

Is Financial Difficulty Really Enough? The Battle of the Circuits to Define Reasonable Cause for Small Businesses' Failure to Pay Taxes

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Notes

IS FINANCIAL DIFFICULTY REALLY ENOUGH? THE BATTLE OF THE CIRCUITS TO DEFINE REASONABLE CAUSE FOR SMALL BUSINESSES' FAILURE TO PAY TAXES

I. INTRODUCTION

Benjamin Franklin stated, "In this world nothing can be said to be certain, except death and taxes."¹ Although everyone is obligated to pay taxes, many small businesses today struggle with paying their taxes at the end of the year due to financial difficulty.² Specifically, small businesses are taking on more debt to pay business expenses.³ In 2016, sixty-one percent of businesses said they experienced financial struggles.⁴ Many small business owners are "digging into their own pockets to pay business expenses" and taxes in order to prevent taking on more debt.⁵ As a result, small businesses are having a difficult time filing in a timely manner and paying their taxes and, in turn, are suffering consequences.⁶

¹ *Nothing Is Certain but Death and Taxes*, THE PHRASE FINDER, <https://www.phrases.org.uk/meanings/death-and-taxes.html> [<http://perma.cc/92RN-K2RV>].

² See Janet Cho, *U.S. Small Businesses Profitable but Facing Challenges*, *Federal Reserve Banks Say*, CLEVELAND (Apr. 24, 2017), http://www.cleveland.com/metro/index.ssf/2017/04/us_small_businesses_profitable_but_facing_challenges_federal_reserve_banks_say.html [<http://perma.cc/EJZ2-JCE5>] (elaborating on the issue that many small businesses struggle harder than corporations and other businesses).

³ See *id.* (examining that the smaller the business is, the less likely it is to receive funding and the more it has to pay out of pocket).

⁴ See *id.* (demonstrating that an additional forty-four percent of small business owners stated that they had problems getting the credit they needed for their business).

⁵ *Id.*

⁶ While one side of the small business world is struggling, another side is not being held accountable. Some successful businesses are not reporting their earnings accurately and, thus, are creating a tax gap. See Stacey Cowley, *Why the I.R.S. Fails to Crack the Small-Business Tax Nut*, N.Y. TIMES (June 15, 2016), <https://www.nytimes.com/2016/06/16/business/smallbusiness/why-the-irs-fails-to-crack-the-small-business-tax-nut.html?mcubz=1> [<http://perma.cc/S4G6-D2DQ>]. Small businesses are notoriously called the "engine of job growth," but recently they are being classified into the category of "tax underpayment." *Id.* Most of the tax gap that the Internal Revenue Service (IRS) estimates is from individual businesses. *Id.* The IRS claims that \$125 billion goes unreported from individual small businesses every year. *Id.* Many small businesses pay expenses through the revenue that comes in, making their cash flows quite hard to navigate and understand. *Id.* By keeping funds from the IRS, small businesses are contributing to the deficit and are not being held accountable. *Id.*

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Currently, penalties are imposed upon small businesses that do not pay or deposit their taxes.⁷ The penalty is a five-percent penalty on the taxable amount for the first month that the business fails to pay, with an additional five percent accumulating each month thereafter.⁸ However, the penalty cannot exceed twenty-five percent.⁹ This penalty is enforced unless the taxpayer can demonstrate that the failure was due to reasonable cause and not willful neglect.¹⁰ In order to show reasonable cause, the taxpayer must show that he exercised ordinary business care and prudence by cutting down on unnecessary expenses.¹¹ In addition to ordinary business care, the taxpayer must also show that paying this tax will cause him undue burden and hardship.¹²

The proof of reasonable cause has been a very controversial topic among the circuits.¹³ In 1994, the Sixth Circuit used a bright-line rule to decide *Brewery, Inc. v. United States*.¹⁴ This bright-line rule states that financial difficulty may never constitute reasonable cause in order to avoid penalties imposed.¹⁵ The Second, Third, Seventh, and Ninth Circuits use a multi-factor test based on two factors: (1) whether the taxpayer favored other creditors over the government; and (2) whether the taxpayer demonstrated a willingness to decrease expenses and personnel.¹⁶ While the bright-line rule is quite narrow, the multi-factor

⁷ See Failure to File Tax Return or to Pay Tax, 26 U.S.C. § 6651(a)(1), (a)(2) (2018) (stating that there will be a penalty for failure to file a tax return or pay tax, but if the taxpayer can show reasonable cause and that this was not due to willful neglect, the taxpayer is not liable for the penalty).

⁸ See *id.* (describing that the amount of penalty imposed will be determined by the number of months that the taxpayer has been delinquent in filing or payment of taxes).

⁹ See *id.*

¹⁰ See *id.*

¹¹ See Failure to File Tax Return or to Pay Tax, Treas. Reg. § 301.6651-1, 26 C.F.R. § 301.6651-1 (Westlaw through 2017) (examining that all facts and circumstances of the taxpayer's financial situation and amount of the expenditures will be considered in the weighing of reasonable cause).

¹² See *id.* (furthering that a taxpayer who "incurs lavish or extravagant living expenses" has not exercised ordinary business care in his tax liability).

¹³ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 800 (5th Cir. 2007) (acknowledging the circuit split on the reasonable cause issue but explaining that this court does not need to examine this current split because regardless the taxpayer will fail either test).

¹⁴ See *Brewery, Inc. v. United States*, 33 F.3d 589, 592 (6th Cir. 1994) (holding that "financial difficulties can never constitute reasonable cause to excuse the penalties for nonpayment of withholding taxes by an employer").

¹⁵ See *id.* (explaining that the court in *Collins v. United States* reached the same conclusion that financial difficulty is not enough to claim a reasonable cause excuse because the taxpayer willfully failed to withhold taxes from the government).

¹⁶ See *Valteau, Harris, Koenig & Mayer v. C.I.R.*, 108 T.C.M. (CCH) 58 (2014) (analyzing that the court in *Staff IT v. United States* also used the multi-factor test to analyze the taxpayer's entire financial circumstances rather than excluding them from the reasonable cause standard).

test is too broad. Economic benefits from using the multi-factor test exist, but the test must be tightened to hold businesses accountable and prevent them from undercutting tax payment.

Therefore, in order to hold businesses accountable while still taking into account financial difficulty, Congress needs to adopt a test that balances both approaches to create a clearly defined standard for all circuits to follow.¹⁷ Part II discusses the background associated with taxation, why taxes are important to our society, small business financial difficulty, and both approaches that are currently in place to define reasonable cause.¹⁸ Part III then examines the existing approaches for defining reasonable cause to determine that financial difficulty is not clearly defined.¹⁹ As a solution, Part IV proposes a new approach that Congress should adopt for all circuits to follow regarding financial difficulty.²⁰ Finally Part V concludes by advocating for the adoption of a new approach that will stimulate economic growth and lessen the obstacles small businesses face, while still recognizing the obligation to pay the government its taxes.²¹

II. BACKGROUND

Given the high percentage of small businesses that fail within a few years after opening their doors, current tax approaches and tests do not provide adequate consideration for the financial difficulty small business faces today.²² This financial difficulty will not be clearly defined unless a

¹⁷ See *infra* Part IV (proposing a new reasonable cause test for all circuits to follow).

¹⁸ See *infra* Part II.

¹⁹ See *infra* Part III (defining the differences between the circuits and what elements need to be in place in a new test to factor in financial difficulty, while still holding businesses accountable for their payment of taxes).

²⁰ See *infra* Part IV (proposing a new approach to resolve the circuit split by using an element approach to determine reasonable cause for financial difficulty).

²¹ See *infra* Part V (concluding that small businesses will still be held accountable for payment of their taxes but will be able to continue operating their businesses if financial difficulty is clearly defined in regards to payment of taxes).

²² See *infra* Part II (identifying the cause for small business failure and the current tax approaches in place that do not help small businesses succeed). The United States Small Business Administration defines a small business either “in terms of the average number of employees over the past 12 months, or average annual receipts over the past three years.” *Qualifying as a Small Business*, U.S. SMALL BUS. ADMIN., <https://www.sba.gov/contracting/getting-started-contractor/qualifying-small-business> [http://perma.cc/S6CV-RG9R]. The Small Business Administration further lists five factors that must be met in order to qualify as a small business. *Id.* The factors are:

is organized for profit; has a place of business in the U.S.; operates primarily within the U.S. or makes a significant contribution to the U.S. economy through payment of taxes or use of American products,

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new test is adopted.²³ Part II explains the reason small businesses struggle today, and why this is a problem, and looks to existing tests that are used in courts.²⁴ First, Part II.A discusses a brief history of taxation, the reason taxes are important, and what taxes fund in our society.²⁵ Second, Part II.B examines small business financial difficulty and economic impacts that small businesses face.²⁶ Next, Part II.C describes the existing *United States Code* and *Code of Federal Regulations* sections that define reasonable cause as provided by the Treasury Regulations.²⁷ Then, Part II.D addresses the Sixth Circuit's approach to define reasonable cause.²⁸ Last, Part II.E explains the Second, Third, Seventh, and Ninth Circuits' approach to define reasonable cause.²⁹

A. *Taxes: What Is the History and Why Are They Important?*

Taxes are "a sum of money demanded by a government for its support or for specific facilities or services, levied upon incomes, property, sales, etc."³⁰ The United States collected very few taxes until 1802.³¹ Taxes officially began in full swing in 1862 during the Civil War when Congress

materials, or labor; is independently owned and operated; and is not dominant in its field on a national basis.

Id. Finally, the Small Business Administration states that "the business may be a sole proprietorship, partnership, corporation, or any other legal form." *Id.* Ultimately, determining what constitutes a small business is dependent on the industry; the Small Business Administration provides a chart that reflects the size standards. *Id.* Small businesses are often defined in contexts such as size of assets, annual revenues, or some other form of financial reporting. Ronald Wilson, *Federal Tax Policy: The Political Influence of American Small Business*, 37 S. TEX. L. REV. 15, 26 (1996) (commenting that there is no simple determination on how to define a small business because it mainly depends on the industry of the business itself). The article further analyzes that the U.S. Internal Revenue Code is not precise either and uses varying definitions of "small" depending on the tax policy. *Id.* at 27.

²³ See *infra* Part IV.

²⁴ See *infra* Part II (reviewing small business financial difficulty and importance of taxation).

²⁵ See *infra* Part II.A.

²⁶ See *infra* Part II.B (analyzing the difficulties that small businesses face and that they are set up to fail).

²⁷ See *infra* Part II.C (explaining the current law that defines the elements of reasonable cause).

²⁸ See *infra* Part II.D (discussing the current bright-line rule that is used in the Sixth Circuit).

²⁹ See *infra* Part II.E (explaining the multi-factor test currently in place).

³⁰ Tax, DICTIONARY.COM, <http://www.dictionary.com/browse/tax> [<http://perma.cc/HDC2-LDUV>].

³¹ See *The History of Income Taxes*, U.S. TAX CTR., <https://www.irs.com/articles/the-history-of-income-taxes> [<http://perma.cc/Z5NF-89T8>]. Taxes were not prevalent in the early years of American history because the country was primarily funded by taxes on goods such as tobacco, carriages, sugar, and alcohol. *Id.* A sales tax on these goods was introduced in 1812 to offset the cost of war and build revenue within the country. *Id.*

adopted income tax as a law for the first time in United States history.³² In 1862, Congress also established the office of Commissioner of Internal Revenue to collect payment and enforce tax laws.³³ Corporate tax first started in 1909 on corporate income in order for the government to raise additional revenue and supervise corporations.³⁴ In 1913, tax, as established by the Commission of Internal Revenue, was permanently added into the United States Constitution by the Sixteenth Amendment.³⁵ Today, businesses account for fourteen percent of the total tax revenue

³² See *id.* (examining that 1862 was the first instance of income tax, and it was much different than the income tax currently in place). Additionally, “a worker who earned \$600 to \$10,000 annually was taxed at a rate of 3%. For those earning more than \$10,000 per year, a higher income tax rate was imposed.” *Id.*

³³ See *id.* (furthering that if the taxes were not paid, the Commissioner of the Internal Revenue had the power to take possession of assets that an individual possessed). This office of Commissioner of Internal Revenue was the first to establish many of the IRS duties and laws carried out and enforced today. In 1906, President Roosevelt proposed a heavily progressive income tax in order to prevent concentrations of wealth. James Repetti, *Democracy, Taxes, and Wealth*, 76 N.Y.U. L. REV. 825, 831 (2001) (stating that the purpose of the tax was to ensure that owners of enormous fortunes did not hand more than a certain amount to any one person). What President Roosevelt was proposing was essentially the estate tax, which “was not actually adopted until 1916.” *Id.* For the first 150 years of American history, the United States government only used inheritance tax during times of hardship until the estate tax was enacted in 1916. *Id.* Additionally, this newly enacted income tax required the Commissioner of Internal Revenue to use assistant assessors to review every single return of every person that filed an income tax for that year. Philip Hackney, *Should the IRS Never “Target” Taxpayers? An Examination of the IRS Tea Party Affair*, 49 VAL. U. L. REV. 453, 472 (2015) (analyzing the current examination process that the IRS uses). When the 1913 income tax was enacted, the IRS could not personally review every return filed by each person because this was an unrealistic task. *Id.* at 473. In fact, at the time of the 1913 income tax, the IRS estimated that about five percent of individual returns should have been investigated further. *Id.*

³⁴ See John VanDenburgh, *Closing International Loopholes: Changing the Corporate Tax Base to Effectively Combat Tax Avoidance*, 47 VAL. U. L. REV. 313, 317 (2012) (discussing that the goal of corporate tax was to provide support for a general individual income tax for American citizens). This tax was put into effect in order for the government to have knowledge about profits and monitor abuse of power. *Id.* When the corporate tax was first enacted, many corporations initially challenged the tax in court, but the Supreme Court upheld the tax because this was the price to pay for the “privilege of doing business in the corporate capacity” in the United States. *Id.* at 318.

³⁵ See *id.* (explaining that this Sixteenth Amendment to the United States Constitution gave Congress the right to assess tax on income earned by not only individuals but also corporations). By 1920, only seven years after the Sixteenth Amendment was added to the Constitution of the United States, the tax revenue reached over \$5 billion. *Id.* In 1986, President Ronald Reagan signed the Tax Reform Act, which reduced individual income taxation and, instead, increased taxation on business. *Id.* The most significant function of this Tax Reform Act was that the maximum income tax rate was reduced from fifty percent to twenty-eight percent. *Id.* Ultimately, many modifications have been made to the United States tax system, including adjusting tax brackets and introducing new low-income tax rates, but the income tax that the Sixteenth Amendment authorized is still alive in the American economy. *Id.*

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that funds and provides for our national defense, health care programs, investments in infrastructure, and education.³⁶

Taxes imposed on businesses come in many different forms, such as federal, state, and local.³⁷ Regardless of the business, every business is required to pay taxes on its income.³⁸ In addition to income tax, businesses also pay sales tax for products and services that they sell.³⁹ Another large tax that businesses face is property tax on real property (real estate).⁴⁰ Employment taxes, or payroll taxes, are also paid by business owners and include taxes such as unemployment, worker's compensation, and social security.⁴¹ These are just a few examples of taxes that businesses must pay, and each tax form depends on the state in which that business is located.⁴²

For most people and businesses, taxes weigh heavily on budgets, but most do not know where tax dollars go and the individual breakdown of which sector of the government they fund.⁴³ In 2016, the United States

³⁶ See *Policy Basics: Where Do Federal Tax Revenues Come From?*, CTR. ON BUDGET POL'Y PRIORITIES (Sept. 5, 2017), <https://www.cbpp.org/research/federal-tax/policy-basics-where-do-federal-tax-revenues-come-from> [<http://perma.cc/H6HN-PK9X>] (examining that in fiscal year 2016, the government spent \$3.9 trillion on services such as national defense, health care programs, etc.). Federal revenues funded \$3.3 trillion of the total \$3.9 trillion that was paid to these public services. *Id.*

³⁷ See Jean Murray, *All the Taxes Your Business Must Pay*, THE BALANCE (Mar. 6, 2017), <https://www.thebalance.com/all-the-taxes-your-business-must-pay-399045> [<http://perma.cc/Z7ZE-9E5G>] (analyzing different taxes depending on the type of business activity). These different taxes include: "selling taxable products or services, using equipment, owning business property, being self-employed, having employees, and, of course, making a profit." *Id.*

³⁸ See *id.* (describing that the income of the business depends on the profits of the company and how this profit is determined depends on the form of the business). Generally, small businesses, partners, and S-corporation business owners pay taxes through their personal income tax returns. *Id.*

³⁹ See *id.* (analyzing that the sales tax is required to be collected by the business owners and is normally paid to the state department of revenue). The reports for these sales tax numbers must be completed and reported on a regular basis. *Id.*

⁴⁰ See *id.* (commenting that if a business owner uses real estate, like a building, to run his or her business, the business owner must pay property tax where the property is located). This real estate tax is based upon the value of the property, but special circumstances exist for paying property taxes that belong to a business. *Id.*

⁴¹ See *id.* (highlighting that employment taxes are paid by the owner of the business based upon the gross pay of total employees that work at the business). Certain taxes, such as unemployment, are not collected from the employee but instead are collected and must be paid by the employer. *Id.*

⁴² See *id.* (pointing out that some states have differing taxes placed on businesses that other states may not implement).

⁴³ See Daniel Kline, *Where Do Your Tax Dollars Actually Go?*, USA TODAY (Apr. 11, 2017), <https://www.usatoday.com/story/money/personalfinance/2017/04/11/where-do-your-tax-dollars-actually-go/100116866/> [<http://perma.cc/3RTC-9SSN>] (explaining that an average American cannot clearly answer the question of where taxes go each year). The

federal government spent \$2.7 trillion tax dollars on social insurance, which is the largest funded sector and includes Social Security, Medicaid, Medicare, unemployment compensation, and veteran's benefits.⁴⁴ The next highest funded government sector is national defense, accounting for fifteen percent of the total spending of the \$3.95 trillion from 2016.⁴⁵ Historically, the federal spending and budget for various sectors account for around twenty percent of gross domestic product (GDP).⁴⁶ Federal revenue in tax collection has financed and provided over \$3.3 trillion for services such as the aforementioned.⁴⁷

In regards to highways, city roads, passenger rails, pedestrian programs, and education, income taxes and general taxes accounted for \$69 billion of spending in 2012.⁴⁸ It is estimated that each U.S. household

article suggests that the average American gives little thought to general taxation and where taxes go. *Id.* This is especially alarming considering that taxes are the single biggest outflow of cash that many Americans will spend each year. *Id.* The current average tax liability for an American is anywhere from \$10,000 to \$15,000 in a given year. *Id.*

⁴⁴ See *The History of Income Taxes*, *supra* note 31. The article also stated that about \$604 billion went toward the national defense fund and about \$114 billion went to education aid and various other social services. *Id.* Additionally, about six percent of the budget goes to net interest, followed by five percent for veteran's benefits, and last, about three percent of the budget goes toward education. *Id.* The remaining six percent of the federal government's spending goes toward other programs such as NASA, national parks, and foreign aid. *Id.*

⁴⁵ See John Schoen, *Here's Where Your Federal Income Tax Dollars Go*, NBC NEWS (Apr. 4 2012), <https://www.nbcnews.com/business/economywatch/heres-where-your-federal-income-tax-dollars-go-654971> [<http://perma.cc/2F6Y-WZQ3>] (explaining that defense costs include: salaries for troops, operating and maintenance costs, research and development, housing the troops, and other research on issues such as atomic energy defense activities). This article specifically throws in a scenario that if the federal budget were \$52,000 a year, which is about the median household income in the U.S., roughly \$200 per week would go to this defense fund for the United States. *Id.* This would total about \$10,400 spending for the entire year on defense. *Id.*

⁴⁶ See *The History of Income Taxes*, *supra* note 31 (examining that, in 2016, total spending was 21.5% of total GDP). In 2016, when the total spending was 21.5% of GDP, the biggest growth and increase in the normal spending came from human service programs such as Medicare and Social Security. *Id.* Additionally, in 2016, the portion of GDP spent on national defense fell to 3.3% after hitting an ultimate high of 6% in 1986. *Id.*

⁴⁷ See *How Do We Fund Our Schools?*, PBS (Sept. 5, 2008), <http://www.pbs.org/wnet/wherewestand/blog/finance-how-do-we-fund-our-schools/197/> [<http://perma.cc/X9HF-MZWM>].

⁴⁸ See Tony Dutzik, *Who Pays for Roads?: How the "Users Pay" Myth Gets in the Way of Solving America's Transportation Problems*, FRONTIER GRP., <https://frontiergroup.org/reports/fg/who-pays-roads> [<http://perma.cc/HUY3-HSFX>] (addressing the myth that only those who use roads and highways pay for maintenance and construction). General taxes by all taxpayers cover nearly just as much of the cost for maintaining and constructing roads and highways as daily users of these roads. *Id.* Transportation costs covered by gasoline taxes are likely to continue to decrease as a result of inflation and the innovation of fuel-efficient cars. *Id.* Finally, in 2012, tolls, user fees (gas tax), and other user taxes only accounted for 49.9% of all state and local expenses on highways and roads. See also Jared Walczak, *How Is Your State's Road Spending Funded?*, TAX FOUND. (Sept. 16, 2015),

pays about \$597 annually in taxes for road construction, repair, and other necessary expenditures for roads.⁴⁹ Additionally, the government spends more on non-user, or non-gas, tax dollars for roads and highways than it does for other forms of transit combined.⁵⁰ Due to K-12 education being funded by individual states, the spending levels will vary state by state, but by far the biggest portion of state tax payments generally goes to classroom funding.⁵¹ The United States government contributes roughly ten cents for every dollar spent on K-12 education, which is less than the majority of countries in the world, so state income tax funding is what most educational institutions rely on.⁵²

As described, taxes are an important aspect of our society as they fund the roads used, provide for national defense, and promote and provide the education of children and those in state universities.⁵³ Consequently, in order for taxes to fund each of these programs, businesses of all kinds will need to be held accountable.⁵⁴ But small businesses, although they drive the economy, often face difficulty in paying their taxes due to countless struggles that they face.⁵⁵ Next, Part II.B discusses the challenges small businesses face and why small business in the American economy is significant.⁵⁶

<https://taxfoundation.org/how-your-state-s-road-spending-funded/> [http://perma.cc/9QGG-V6EV].

⁴⁹ See *Policy Basics: Where Do Federal Tax Revenues Come From?*, *supra* note 36 (describing that all Americans bear the costs of road construction and repair, not just those who utilize the roads on a daily basis through the gas tax). Roughly \$216 per year per household went toward vehicle crashes, through government expenditures. *Id.*

⁵⁰ *Id.* (stating that transit accounted for \$43.3 billion in government spending). Bicycling pedestrian programs account for \$821 million, and passenger rail received \$1.8 billion in government funding. *Id.*

⁵¹ *Id.* (addressing that about twenty-six percent, or \$260 billion, of all state spending goes to K-12 education funding). *Id.* Additionally, another thirteen percent, or \$130 billion, went to various state universities, technical schools, and community colleges. *Id.*

⁵² See Murray, *supra* note 37 (stating that state and local governments fund approximately ninety-three percent of all education expenditures). The majority of this funding comes from income taxes, both corporate and personal. *Id.* A study conducted by the Funding Gap, which is a nonprofit group for The Education Trust, found that many states “provide the least amount of funding to school districts” so that they can barely get by. *Id.*

⁵³ See discussion *supra* text accompanying notes 37-52.

⁵⁴ See discussion *supra* text accompanying notes 34-52 (explaining that taxes are an important aspect of our society, but without businesses being held accountable for these taxes, society will not benefit and these programs will not be as heavily funded).

⁵⁵ See *infra* Part II.B.

⁵⁶ See *infra* Part II.B.

B. *Why Do Small Businesses Face Financial Difficulty?*

Despite the fact that small businesses provide for much of our economic growth and nearly half of the jobs in the U.S. workforce, small businesses struggle in a variety of ways.⁵⁷ First, Section II.B.1 discusses the significance of small businesses in the American economy and the benefit they provide to disadvantaged groups who otherwise would not be able to achieve financial success.⁵⁸ Then, Section II.B.2 examines the impact that the recession had on small businesses and why they experienced great financial difficulty.⁵⁹ Finally, Section II.B.3 explains the tax obligations that small businesses face and why they are major contributors to the downfall of a business.⁶⁰

1. The Significance of Small Businesses in the American Economy

Small business owners in the United States make up a significant portion of the economy.⁶¹ Small businesses drive the economy and provide significant economic growth.⁶² The U.S. Small Business Administration agrees with the Global Entrepreneurship Monitor that “[t]here is a strong correlation between national economic growth and the level of national entrepreneurial activity.”⁶³ Small businesses generate and provide for over fifty percent of the total United States private GDP, and in 2001, they generated twenty-nine percent of all United States exports.⁶⁴ Many people living in the United States believe that starting a

⁵⁷ See Rafael Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, 4 HASTINGS BUS. L.J. 175, 176 (2008) (examining that many small businesses fail every year with thirty percent closing within two years of opening).

⁵⁸ See *infra* Section II.B.1 (discussing that small businesses drive the American economy and employ most of the American workforce).

⁵⁹ See *infra* Section II.B.2.

⁶⁰ See *infra* Section II.B.3.

⁶¹ See Efrat, *supra* note 57, at 176 (stating that small business owners make up six percent of the total adult population in the United States and eleven percent of working Americans). Additionally, small business owners are the engine that drives innovation, and an average of half a million new businesses are created each month in the United States. *Id.* In 2006, nearly 465,000 new businesses were created each month. *Id.*

⁶² See Murray, *supra* note 37 (demonstrating that small business owners employ over half of the American labor force and, additionally, create over sixty percent of new jobs in the United States each year).

⁶³ Don B. Bradley III & Chris Cowdery, *Small Business: Causes of Bankruptcy*, UNIV. OF CENT. ARK. 205, 205 (2004), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.367.4484&rep=rep1&type=pdf> [<http://perma.cc/DHH8-UC9D>] (quoting the Small Business Administration).

⁶⁴ See *id.* (furthering that small businesses are fifty percent more likely to be in the top percentage of those common patents specified in the United States market). Additionally, small self-employed firms employ nearly thirty-nine percent of the total high-tech industry

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small business and owning it from the ground up is the American dream.⁶⁵ Not only are small business owners benefiting the American economy as a whole but also small businesses are giving entrepreneurs advantages over regular salary-paid workers.⁶⁶ As discussed, small businesses have a significant impact on the national economy and are also imperative in creating jobs and overall employment.⁶⁷

Small businesses have provided many disadvantaged groups with employment and have also been a key factor in the overall health of the economy.⁶⁸ The majority of U.S. adult workers first entered the job market by working for a small business.⁶⁹ In 2001, small business owners employed 57 million of the 115 million total private workers.⁷⁰ Additionally, in 2003, of the total 23.7 million businesses in the U.S. economy, 17 million of those businesses were sole proprietorships.⁷¹

in the United States, which shows that self-employed business owners implement efficiency and innovation. *Id.* at 205–06.

⁶⁵ See *id.* at 205 (exploring that many entrepreneurs see significant advantages in small business ownership such as: the luxury of no boss to report to; the knowledge that the work that one puts in is his or her success alone; and the excitement of ownership).

⁶⁶ See Efrat, *supra* note 57, at 176 (examining that studies conducted in the United States economy have found that self-employed business owners earn significantly higher income than normal salaried workers). Additionally, small business owners have a higher net worth than non-small business owners due to the entrepreneurship that is required. *Id.* Finally, small business owners are more likely to earn higher income and achieve success, given the odds of failure, due to their superior human capital. *Id.* In the United States, only a quarter of the entire population earned a bachelor's degree or higher. *Id.* Small business owners are two times more likely to have obtained degrees. *Id.* This analysis of small business owners proves and demonstrates that self-employed workers are known to work harder and also take on more risk, as opposed to a normal salaried worker. *Id.*

⁶⁷ See Efrat, *supra* note 57, at 176 (observing that small businesses dominate job growth in the American economy and employ more than half of the American labor force each year).

⁶⁸ See *id.* (explaining that the disadvantaged groups that small business ownership has helped are women, immigrants, and minorities). These disadvantaged groups are gaining access to critical career opportunities through small business employment. *Id.*

⁶⁹ See *The Importance of Small Business to the U.S. Economy*, UMN LIBR., <http://open.lib.umn.edu/exploringbusiness/chapter/5-2-the-importance-of-small-business-to-the-u-s-economy/> [<http://perma.cc/4CJP-4S74>] (outlining that small companies and firms are more likely to hire and fire workers more frequently than larger firms and, thus, are able to employ more workers).

⁷⁰ See Bradley & Cowdery, *supra* note 63, at 206 (furthering that in a given year, small businesses are responsible for employing and creating anywhere between sixty and eighty percent of new jobs in the economy). Between 2000 and 2001, without small business owners, the United States economy would have had a decrease in job creation. *Id.* Between those years, small businesses created just over one million jobs, while large companies had a decrease of about 150,000 jobs. *Id.*

⁷¹ See *id.* (recognizing that of those 23.7 million total businesses in the economy, ninety-nine percent of that total employed 500 or less individuals per business). This shows that small firms are targeting different demographics of workers in the American economy, and

Finally, small businesses are the key factor through which many disadvantaged groups, like women and minorities, are able to achieve financial success.⁷² Although small businesses have proven to be essential in the growth of the economy and an opportunity for disadvantaged groups, small businesses face many challenges that force them to close their doors within a short period of opening.⁷³

2. Challenges Faced by Small Businesses and the Impacts of the Recession

According to a report by the U.S. Small Business Administration, five major challenges that small business owners face include: “(1) strengthening the overall economy, (2) taxes and regulation, (3) the cost and availability of health insurance, (4) attracting and retaining a quality workforce, and (5) global competition.”⁷⁴ Small business owners often cite tax and various regulatory policies as a major concern.⁷⁵ Additionally, small businesses face disproportionate compliance costs in regards to federal regulations for each employee than larger businesses

small businesses are more likely to hire workers that are younger, can only work part-time hours, or might be older and past the retirement age. *Id.*

⁷² See *The Importance of Small Business to the U.S. Economy*, *supra* note 69 (recognizing that while the majority of small businesses are still owned by Caucasian males, the past twenty years have shown that this is steadily changing). In 1982, only about 3000 businesses were owned by women. *Id.* In 2010, however, about 8000 small businesses were owned by women. *Id.* This shows that, in twenty-eight years, the number of women owning small businesses more than doubled. *Id.* See also Silvana Ordonez, *Minorities: The Force Fueling Small-Business Growth*, CNBC (May 12, 2014), <https://www.cnbc.com/2014/05/12/minorities-the-force-fueling-small-business-growth.html> [<http://perma.cc/4XJW-YRX5>] (noting that minorities account for almost fifteen percent of the total number of small businesses in the United States and employ nearly 5.9 million workers). This article further examines how Patty Paredes used her savings to open her own nail salon. *Id.* Paredes used to work ten-hour days as a manicurist, and she used her own savings to get out of the rut she was in and created her own business. *Id.* The article further states that in 2007, in the United States, African Americans owned 1.9 million small businesses, Native Americans owned 0.3 million, and Asians owned 1.6 million. *Id.* The article concludes that entrepreneurship provides a more “economically viable path” to immigrants who may not have the same advantages that Americans who have lived in the United States all of their lives have. *Id.*

⁷³ See Efrat, *supra* note 57, at 176 (discussing that thirty percent of new businesses close within two years of opening their doors, and over half close within four years of the same). Knowledge is limited as to why so many small businesses fail each year, but the reasons can be analyzed through various aspects of business operation. *Id.*

⁷⁴ Chad Moutray, *Looking Ahead: Opportunities and Challenges for Entrepreneurship and Small Business Owners*, U.S. SMALL BUS. ADMIN. 1, 2 (Oct. 2008), <https://www.sba.gov/sites/default/files/rs332tot.pdf> [<http://perma.cc/C4JN-GPH7>].

⁷⁵ See Murray, *supra* note 37 (furthering that tax rates influence the firm formation of businesses, and additionally, state policies can promote business creation and lead to higher employment levels).

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with more employees.⁷⁶ Many current federal tax provisions expired after fiscal year 2010, and the need for minimum taxes will need to be discussed by government leaders at some point.⁷⁷ Regarding health insurance, premiums have risen substantially, and the cost of “employee-sponsored health insurance plans has increased 119 percent since 1999, with a five percent increase in 2008 from the previous year.”⁷⁸ Small businesses face many challenges in today’s economy, but another aspect that hit small businesses deeply was the recession.⁷⁹

Following the Great Recession, “[F]ederal revenues coming from individual income plus payroll taxes has grown, while the share coming from corporate taxes and other revenue has fallen.”⁸⁰ This is due to policies enacted to combat the effects of the Great Recession, such as temporary tax cuts.⁸¹ In 2007, “Revenues fell from 17.9 percent of gross

⁷⁶ See Moutray, *supra* note 74, at 3. Further, the federal government and many states have fought for regulations that give small businesses protection. *Id.* As documented by the World Bank, other nations are trying to push for protections to reduce business regulatory barriers. *Id.* at 3–4. Also, due to this push, overall business activities in these nations that are pushing for such reductions are increasing as a result. *Id.*

⁷⁷ See Efrat, *supra* note 57, at 176. As many new regulations are put into place by state and federal governments, small business interests will need to be considered. *Id.*

⁷⁸ Moutray, *supra* note 74, at 4. Small businesses have pursued options such as sharing the cost of coverage with employees, using consumer-driven plans as a lower-cost option, and choosing not to offer health insurance for employees at all. *Id.* Further, research shows that employees at smaller businesses are less likely to receive health insurance and other benefits than those employees working at larger businesses. *Id.* In 2008, only sixty-two percent of businesses with fewer than 200 employees offered such health insurance benefits, while virtually all of the employers with more than 200 employees offered health benefits to their workers. *Id.* at 4–5. Additionally, with a small business of three to ten employees, the health-benefit rate was forty-nine percent. *Id.* at 5. This shows the challenge of cost increase of health insurance coverage for smaller business firms and the disproportional advantage that larger businesses have over smaller firms. *Id.* The article concludes its discussion regarding health insurance by stating that there have been several legislative proposals, none of which have ever passed Congress. *Id.*

⁷⁹ See *Policy Basics: Where Do Federal Tax Revenues Come From?*, *supra* note 36 (explaining the dramatic decrease in revenue from businesses and the temporary tax cuts).

⁸⁰ *Id.*

⁸¹ See *The History of Income Taxes*, *supra* note 31 (explaining that during the Great Recession, due to the poor economy, the government had to change its policies and respond quickly). See also Robert Rich, *The Great Recession*, FED. RESERVE HIST., https://www.federalreservehistory.org/essays/great_recession_of_200709 [http://perma.cc/VKB4-Z6YF] (demonstrating the history of the Great Recession and the effects on the economy). The article discusses that the unemployment rate during the Great Recession period was at five percent in 2007, and rose to 9.5 percent by 2009. *Id.* The financial crisis deepened, and measures were quickly implemented to revive the economic growth. *Id.* The economic measures included the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009. *Id.* See also Christian Weller, *10 Reasons Why Public Policies Rescued the U.S. Economy*, AM. PROGRESS (May 2012), <https://www.americanprogress.org/issues/economy/news/2012/05/29/11593/10-reasons-why-public-policies-rescued-the-u-s->

domestic product in 2007 (the last fiscal year before the recession) to 14.6 percent in 2009 and 2010,"⁸² and have since recovered back to 17.8 percent in 2016.⁸³ During recessions, such as the one in 2007, small businesses are often hit the hardest.⁸⁴ Small businesses experience reduced cash flow, loss of demand, staffing reductions, and various marketing constraints.⁸⁵ According to a National Federation of Independent Business survey, small business owners identified that the most pressing problem with weak economic conditions is poor sales.⁸⁶ These factors contributed to the downfall of small businesses during the recession, but small businesses

economy/ [<http://perma.cc/EXA4-3VEU>] (examining the acts and programs that were put into place to offset the economic downturn). The American Recovery and Reinvestment Act implemented a series of tax cuts. *Id.* Additionally, Congress enacted new payroll tax cuts, and after these policies and acts were implemented, the economy and the labor markets started to improve quickly. *Id.*

⁸² *The History of Income Taxes*, *supra* note 31.

⁸³ *Id.*

⁸⁴ See Tracey Sandilands, *Effect of Recession on Small Businesses*, CHRON, <http://smallbusiness.chron.com/effect-recession-small-businesses-61164.html> [<http://perma.cc/F4RG-NZRJ>] (discussing that budget constraints and reduced spending power among consumers make it impossible for a small firm to survive during a recession, mainly because businesses cannot prepare).

⁸⁵ See *id.* Small businesses operate on a very tight cash flow because they usually do not have many cash resources readily available to them. *Id.* Thus, money comes and goes very steadily, and in a recession, this already strained cash flow becomes even tighter and causes many businesses to suffer. *Id.* Additionally, small businesses generally rely on a few bigger customers that support the majority of their revenue. *Id.* When a recession occurs, customers could lose a significant amount of income, and if a larger customer ends up going out of business, it could potentially fail to pay the small business any money that it currently owes. *Id.* In regard to staffing reductions, loss of revenue in businesses will lead to financial deficits, which will normally result in budget cuts whenever it is possible. *Id.* The first step a business owner will take is to reduce staff because it is easier to cut employees than to escape a business contract with another company or supplier. *Id.* Finally, marketing is one of the first activities to be cut when a business faces financial constraint, which may be detrimental to the overall health of the business in the long run due to no new customers being brought into the market of the business. *Id.*

⁸⁶ See Aysegul Sahin, *Why Small Businesses Were Hit Harder by the Recent Recession*, 17 N.Y. FED. RES. 1, 1, https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci17-4.pdf [<http://perma.cc/UY33-GREA>] (establishing that poor sales, an answer in this survey, have increased dramatically, while other factors, such as the availability of labor, have decreased in importance). Most firms report that their decrease in performance and revenue is the result of lack of insight into current and future demands for goods and services. *Id.* Also, this article discusses that small businesses attribute the decline in sales and revenue during the recession to poor sales and economic uncertainty. *Id.* at 2. Finally, small businesses have a constrained access to credit, and due to this, the economic conditions of the recession made it hard for small businesses to put money into new investments. *Id.* at 3.

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also face tax burdens every year that have been the reason many small businesses close their doors.⁸⁷

3. The Tax Burden of Small Business Owners

Small business owners often cite taxes as a serious problem.⁸⁸ Small business owners face disproportionate tax burdens in operating their businesses, as the federal tax code gives mixed treatment from small to large business owners.⁸⁹ In a study examining small business disadvantages, one researcher found that small businesses pay corporate tax rates of twenty-five to thirty percent, which is about six to eight percent higher than large businesses' corporate tax rates.⁹⁰ Additionally, the tax code disfavors small businesses by limiting the options they have in selecting a tax year.⁹¹ As if these tax burdens on small businesses are not enough, the tax burden has increased even more due to the rising costs

⁸⁷ See Efrat, *supra* note 57, at 179 (explaining that outside of bankruptcy, taxes were mentioned as a serious problem by many small business owners and a challenge that they face every year).

⁸⁸ See Policy Basics: *Where Do Federal Tax Revenues Come From?*, *supra* note 36.

⁸⁹ See Efrat, *supra* note 57, at 180 (stating that small business owners have some federal tax benefits such as: "progressive corporate tax rate structure[s], the expensing allowance for certain equipment under section 179, the cash basis accounting, and the exclusion from taxation of capital gains of certain small-business stock"). Legislatures attempted to fix the issue of disproportionate research and development deductions for taxable years. See Research and Experimental Expenditures, 26 U.S.C. § 174 (2012) (providing the treatment for such expenses of research and development and the method and scope in which the expenses apply to taxes). Section 174 allows a taxpayer to deduct research and experiential expenditures paid during the taxable year that are in line with the trade of the taxpayer's own business. William Natbony, *The Tax Incentives for Research and Development: An Analysis and a Proposal*, 76 GEO. L.J. 347, 355 (1987) (analyzing that the Section 174 deduction is highly technical). The Section 174 deduction is of greater value to large and more profitable businesses because of their higher tax brackets. *Id.* at 355–56. The article states an example that "a successful corporation spending \$100 on qualifying R&D under section 174 will be entitled to a subsidy of \$34. In contrast, a middle-income individual with \$25,000 in income spending \$100 on R&D will be entitled to a current federal R&D subsidy of only \$15" *Id.* (footnote omitted). Therefore, the Section 174 R&D deduction does not serve the purpose of encouraging entrepreneurial innovation from small businesses because there is simply no incentive to do so. *Id.*

⁹⁰ See Efrat, *supra* note 57, at 181 (exploring that the Internal Revenue Code has unfavorably treated small businesses differently than large businesses and has singled them out). Additionally, tax treatment of small businesses is expressed by various fringe benefits that have been created as provisions in the tax code. *Id.* at 181–82. The eligibility rules of these provisions make it hard for small business owners to take advantage of these opportunities and benefits. *Id.* at 181.

⁹¹ See *id.* at 182 (identifying that C-corporations are given many more options and more flexibility in deciding their taxable year and do not have to take a twelve-month, or full, fiscal year). Also, the current tax code puts more power with large businesses by giving them lenient requirements for extending filing deadlines. *Id.*

of tax compliance.⁹² Due to these disadvantages in tax burdens faced by small business owners, the current progressive tax rate acts as an inhibitor on success and growth in self-employment and entrepreneurship.⁹³ These have proven to be major factors in the growth of the economy due to the added burden on small business owners and the lack of resources they have available to them.⁹⁴ Next, Part II.C discusses the relevant *United States Codes* and *Code of Federal Regulations* for the failure to file taxes.⁹⁵

C. *An Examination of the Relevant Codes for Failure to File or Pay Taxes*

The *United States Code*, 26 U.S.C. § 6651, is the authority given to assess the penalties imposed and definitions for failure to file a tax return.⁹⁶ Additionally, 26 U.S.C. § 6656(a) provides the definition for underpayment of deposits and says:

[I]n the case of any failure by any person to deposit (as required by this title or by regulations of the Secretary under this title) . . . unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be imposed upon such person a penalty equal to the applicable percentage of the amount of the underpayment.⁹⁷

⁹² See *id.* (highlighting that tax compliance costs “include the costs of meeting the substantive requirements of the tax code, administration and paperwork costs involved in complying with the regulatory framework, the costs arising from the disincentives and duplications attributable to the regulatory framework, and the psychological stress associated with compliance”). In 2004, the estimated cost of tax compliance costs reached \$100 billion and the estimated time spent on such compliance was six billion hours. *Id.* The article further suggests that the reason the tax code is continuing to become more complex is due to the addition of code sections. *Id.* “In 1955 the federal income tax law was comprised of 103 code sections. By 2002, there were 725 income tax code sections, a 604 percent increase.” *Id.* Finally, various studies have found that small firms spend much more on tax compliance than large firms. *Id.* at 182–83. One study found that the cost of tax compliance is sixty-seven percent higher in small businesses than in larger businesses. *Id.* at 183.

⁹³ See *id.* (addressing that the tax burden remains a high issue among small businesses and many owners report that they feel immense pressure to meet the tax obligations). Studies have shown that the additional tax burdens are an impairment on the profitability of small business owners. *Id.* This eventually leads some businesses to close down because their profit margins do not serve as a means to keep the business open. *Id.* at 184. Finally, these burdens cause slower entrepreneurial growth and slower rates of hiring, both of which hurt the American economy. *Id.*

⁹⁴ See *id.* at 184–85 (explaining that due to these increased burdens, small businesses are even more likely to fail and inhibit economic growth).

⁹⁵ See *infra* Part II.C.

⁹⁶ See Failure to File Tax Return or to Pay Tax, 26 U.S.C. § 6651 (2018).

⁹⁷ Failure to Make Deposit of Taxes, 26 U.S.C. § 6656(a) (2018).

Section 6651 states:

In case of failure to file any return required . . . on the date prescribed . . . unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, which an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate.⁹⁸

The *Code* provides that there shall be an added penalty per month for each month the taxpayer fails to file a tax return or pay taxes.⁹⁹ In order to prove that this failure to pay is not due to willful neglect, 26 C.F.R. § 301.6651 defines how to show reasonable cause.¹⁰⁰

Furthermore, this regulation provides that a showing of reasonable cause will be met by “exercis[ing] ordinary business care and prudence in providing for payment of the tax. This may exist if enough funds were on hand but because of unanticipated events the taxpayer was unable to pay the taxes.”¹⁰¹ The regulation also illustrates that, in order to establish

⁹⁸ *Id.*

⁹⁹ *See id.* (discussing that for every additional month the failure or neglect continues, five percent will be added to the overall tax payment). Each month will constitute a five-percent increase on the total amount of taxes owed, but the percentage cannot exceed twenty-five percent in the aggregate. *Id.*

¹⁰⁰ *See* Failure to File Tax Return or to Pay Tax, Treas. Reg. § 301.6651-1, 26 C.F.R. § 301.6651-1, (Westlaw through 2017) (explaining that this affirmative showing of reasonable cause must be in the form of a written statement that contains a declaration that all statements are made under additional penalties of perjury). *See also Lack of Funds*, 2 Tax Pen. & Int. § 9:14 (2017) (emphasizing that lack of funds has not risen to the level to constitute reasonable cause). Section 9:14 of Tax Penalties and Interest also states that “the taxpayer must show more than mere inability to pay.” *Id.* Section 9:14 further develops that taxpayers “must show that they exercised ordinary business care and prudence in providing for payment of the tax.” *Id.* Tax Penalties and Interest provides that ordinary business care may be established if “enough funds were on hand but because of unanticipated events the taxpayer was unable to pay the taxes.” *Id.* Finally, this section of Tax Penalties and Interest addresses two factors in which inability to pay may be a factor for tax relief. *Id.* The two factors are: “(1) [t]he taxpayer shows that, had payment been made on the due date, undue hardship would have resulted[; and] (2) [i]f the taxpayer files bankruptcy, inability to pay is a factor if the insolvency occurred before the bankruptcy.” *Id.*

¹⁰¹ *Id.* Further, § 9:14 of Tax Penalties and Interest states five considerations with respect to undue hardship. *Lack of Funds*, 2 Tax Pen. & Int. § 9:14 (2017). The five factors for undue hardship are:

(a) when did the taxpayer know he could not pay; (b) why was the taxpayer unable to pay; (c) did the taxpayer explore other means to secure the necessary funds; (d) what did the taxpayer supply as proof,

reasonable cause, all facts and circumstances will be assessed to determine the taxpayer's financial situation.¹⁰² Additionally, the taxpayer bears the heavy burden "(1) that the failure did not result from 'willful neglect,' and (2) that the failure was 'due to reasonable cause.'"¹⁰³ On the contrary, in order to determine if a taxpayer exercised ordinary business care and prudence, it will be assessed if he made a reasonable effort to conserve enough assets to satisfy his tax liability.¹⁰⁴ Although reasonable cause does have a solid definition in the *Code of Federal Regulations*, the application of reasonable cause for financial difficulty by various circuits has been a highly debated issue.¹⁰⁵ Next, Part II.D will analyze the Sixth Circuit's application for reasonable cause.¹⁰⁶

D. The Sixth Circuit's Bright-Line Application for Reasonable Cause

The Sixth Circuit has consistently stated that financial difficulties can never constitute reasonable cause to excuse the penalties for nonpayment of taxes.¹⁰⁷ In *Brewery, Inc. v. United States*, the owners of Brewery, Inc. ("Bogey Inn") decided to expand and remodel their restaurant.¹⁰⁸ In

such as bank statements; (e) and did the taxpayer pay when the funds became available.

Id.

¹⁰² See § 301.6651-1 (furthering that the facts and circumstances of financial situations include: the amount of the taxpayer's expenditures on various assets despite the income level received; if the taxpayer incurred lavish or extravagant living expenses in an amount that the remainder of his assets would not be enough to pay for this tax liability; and if a taxpayer invests in funds that are speculative). The regulation further states that if any of these occurred, while not being aware of the remainder of the taxpayer's assets that would be sufficient enough to pay his tax, then the taxpayer has not exercised ordinary business care and prudence and thus does not constitute a showing of reasonable cause. *Id.*

¹⁰³ *United States v. Boyle*, 469 U.S. 241, 245 (1985).

¹⁰⁴ See § 301.6651-1 (examining what constitutes ordinary business care and prudence to show a satisfactory finding of reasonable cause). Additionally, consideration of the tax that the taxpayer failed to pay will also be a factor in the determination of ordinary business care and prudence. *Id.*

¹⁰⁵ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 800 (5th Cir. 2007) (acknowledging the circuit split on the reasonable cause issue but refraining from examining the issue further because regardless the tax payer would fail either test). The court further addressed that under either the bright-line rule or multi-factor test, the corporation in *Staff IT* was not entitled to ignore tax penalties because it failed to exercise ordinary business care and prudence. *Id.*

¹⁰⁶ See *infra* Part II.D (addressing the current cases and precedent established by the Sixth Circuit).

¹⁰⁷ See *Brewery, Inc. v. U.S.*, 33 F.3d 589, 592 (6th Cir. 1994).

¹⁰⁸ See *id.* at 591 (acknowledging that the expansion of the restaurant required the installation of a new sewer system, and this expense was to be shared with several other area property owners). Due to this sharing of the cost, one of the property owners went out of business, and Bogey Inn was expected to pay its share of what was owed. *Id.* This meant

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addition to having to pay extra remodeling costs that the owners of Bogey Inn were not expecting, the City of Columbus renovated a bridge over the Scioto River, and this renovation took place almost directly in front of Bogey Inn.¹⁰⁹ Bogey Inn was informed that the bridge would not open for another two years, and as a result, Bogey Inn experienced operating losses of \$4200.¹¹⁰ The Bogey Inn favored other creditors over the IRS due to the loss of revenue, paid penalties pursuant to 26 U.S.C. § 6651(a)(1), and then filed a claim for refund claiming that this failure to pay the IRS was due to reasonable cause.¹¹¹ The district court found that taxes are for the exclusive use of the government, and the use of these trust-fund taxes as payment to other creditors cannot constitute reasonable cause for abatement of penalties.¹¹²

Additionally, in *Collins v. United States*, Collins was a certified public accountant and a shareholder of the corporation Stinger Boats.¹¹³ In 1980, at the request of the corporation's majority holder, Collins took over

that the actual cost of remodeling Bogey Inn, in addition to the unexpected charge for sewage, was \$900,000 instead of \$600,000. *Id.*

¹⁰⁹ See *id.* (observing that this route cut off access to the restaurant of Bogey Inn and, consequently, revenue dropped). From 1988 to 1990, the Bogey Inn withheld federal income from the paychecks of its employees but did not "timely deposit the withheld taxes or pay the employer's share of FICA and Medicare taxes over to the IRS." *Id.*

¹¹⁰ See *id.* (pointing out that due to this period of negative cash flow, the owners of Bogey Inn stated in their complaint that some creditors had to wait for their payments, and unfortunately, Bogey Inn decided the IRS was one of those creditors that would have to wait).

¹¹¹ See *Brewery*, 33 F.3d at 591 (declaring that the IRS denied the refund claims and Bogey Inn appealed this decision). Due to Bogey Inn having weekly tax liability exceeding \$3000, it was required to make weekly deposits of the federal employment tax due from previous weeks of missed payments. *Id.* Bogey Inn was additionally required to file a quarterly federal tax return, along with payment for that quarter. *Id.* Bogey Inn stated that it made a willful decision to pay creditors ahead of the government and used the funds that were held in trust as available funds that could be used by the business. *Id.*

¹¹² See *id.* at 592 (holding that the facts and circumstances required to assess reasonable cause must be particularly compelling in order to have a true finding of reasonable cause, which will allow the taxpayer a pass to avoid penalties imposed). The court further stated that "it is no excuse that, as a matter of sound business judgment, the money was paid to suppliers and for wages in order to keep the corporation operating as a going concern—the government cannot be made an unwilling partner in a floundering business." *Id.* The court found that Bogey Inn willfully chose to invade the funds held in trust for the government in order to keep the business running and pay other creditors for operating expenses. *Id.* The court stated that Bogey Inn cannot now claim that this willful decision to pay other creditors constituted reasonable cause because this was not a situation where no funds were available; funds were available, but Bogey Inn chose to use the funds elsewhere. *Id.* The court affirmed the decision of the district court and stated that Bogey Inn's failure to pay these taxes was not due to reasonable cause and, instead, constituted willful neglect. *Id.*

¹¹³ See *Collins v. United States*, 848 F.2d 740, 741 (6th Cir. 1988).

review of the financial position of the company.¹¹⁴ Collins joined Stinger Boats as president in 1980 and remained in this position until operations of the corporation ceased later the same year.¹¹⁵ During the time that Collins managed the corporation, he paid withheld taxes to the government until July but failed to pay withheld taxes in the months of August and September.¹¹⁶ However, during August and September, when he failed to pay these taxes, Collins paid for utilities, supplies, and rent.¹¹⁷ At trial, Collins stated that he had not willfully failed to pay the taxes that were due to the government because he relied on the oral promise of the company's majority shareholder, Polk, that he would supply all working capital necessary, but Polk did not keep this promise.¹¹⁸ The court stated that the trust-fund taxes "are for the exclusive use of the government and cannot be used to pay business expenses of the employer, including salaries."¹¹⁹ The court held that "[a] responsible person who makes a deliberate choice to voluntarily, consciously, and intentionally pay other creditors rather than make tax payments, is liable

¹¹⁴ See *id.* (defining that as of March 1980, the liabilities of Stinger Boats exceeded its assets by approximately \$600,000). After finding this information, Collins discussed the corporation's financial situation with Polk, the majority shareholder. *Id.* Polk asked Collins to turn the company around and leave his current employment to manage the company. *Id.* Collins did so, and Polk agreed to loan the company his own assets that Collins deemed necessary to give the company working capital. *Id.*

¹¹⁵ See *id.* (discussing that during the period that Collins was president, the company received \$220,000 in capital loans from Polk and earned revenue of roughly \$80,000 a month from boat sales). Collins went to Louisiana to discuss with Polk the financial problems within the company and that prospects were still not looking good. *Id.* Polk agreed to give more of his personal assets to Stinger Boats and ended up giving \$45,000 in additional capital to Collins. *Id.*

¹¹⁶ See *id.* (explaining that the corporation fell about \$500 short of payment during these months, so Collins chose not to pay during the months of August and September).

¹¹⁷ See *id.* (discussing that employees were paid during this time period each week through October 24). The taxes withheld amounted to a total of \$18,083.04 for the third and fourth quarter of operation that were not paid over to the government. *Id.*

¹¹⁸ See *id.* (examining that Collins had intended on using the portion of the \$45,000 check sent by Polk to pay the taxes that were owed, but Collins could not do so because Polk had stopped payment on the check). Collins did admit to knowing that he had an obligation to pay the taxes and failed to do so. *Id.* Collins also stated that he was aware of the overdue payment of the withheld taxes to be made to the government and paid company expenses and wages instead. *Id.*

¹¹⁹ See *Collins v. United States*, 848 F.2d 740, 745 (6th Cir. 1988) (explaining that no excuse existed that the money was paid to suppliers and for wages in order to keep the business at an operating level). The court further reasoned that the intent of Congress was that the person responsible for paying the taxes over to the government should be liable for a missed payment. *Id.* The court further stated that the taxpayer's burden includes proving that he was not a responsible person who "willfully failed to pay over the withheld taxes." *Id.* The evidence is undisputed that Collins was the person that was responsible for taking over the corporation's responsibilities for paying taxes to the government due to his position as president in the Stinger Boats corporation. *Id.*

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for willful failure.”¹²⁰ Also, the court reasoned that willfulness was established because Collins had the corporation pay wages and suppliers, while knowing that the corporation was indebted for the taxes owed to the government.¹²¹ Next, Part II.E discusses the approach that the Second, Third, Seventh, and Ninth Circuits use to determine reasonable cause.¹²²

E. *An Examination of the Second, Third, Seventh, and Ninth Circuits’ Multi-Factor Test to Determine Reasonable Cause*

The circuits that use the multi-factor test find that the bright-line rule that the Sixth Circuit implements is troubling.¹²³ *Staff IT, Inc. v. United States* describes the two-part, multi-factor test used by these circuits, which states:

[T]he primary factors in determining whether a taxpayer exercised ordinary business care are (1) the taxpayer’s favoring of other creditors over the government, which weighs against a finding of reasonable cause, and (2) the taxpayer’s willingness to decrease expenses and personnel, which weighs in favor of a finding of reasonable cause.¹²⁴

The court in *Staff IT, Inc.* determined that it would use the multi-factor test instead of the bright-line rule to assess whether the company willfully neglected its duty to pay taxes to the government.¹²⁵ The court determined that, as for the financial troubles that Staff, IT incurred, it still

¹²⁰ *Id.* at 742.

¹²¹ *See id.* (addressing that Collins’s testimony offered evidence that he voluntarily, consciously, and intentionally paid other creditors rather than paying taxes owed to the government). Collins’s testimony further offered that he paid wages for employees and other supplies that were necessary for business operation and other business expenses. *Id.* Collins’s reliance upon Polk’s promise that he would provide the corporation with capital from his own personal assets did not make him less willful. *Id.*

¹²² *See infra* Part II.E (expanding on the current definition of reasonable cause as used by the Second, Third, Seventh, and Ninth Circuits).

¹²³ *See E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 507 (3d Cir. 1999) (examining that such use of a bright-line rule is inconsistent with Congress’s creation of a reasonable cause exception because it fails to examine all facts and circumstances that are inhibiting the taxpayer from payment of taxes to the government).

¹²⁴ *Staff IT, Inc. v. United States*, 482 F.3d 792, 801 (5th Cir. 2007).

¹²⁵ *See id.* (explaining that the court would not weigh each test specifically, but the court determined the multi-factor test was appropriate to apply to the facts of the case). The court reasoned that the *Brewery* approach, as used by the Sixth Circuit, disregards the language and intended purpose of the applicable laws imposed by Congress. *Id.* The court ultimately determined that a circuit split on the reasonable cause issue exists, but under either test, S.I., the business at fault, would still fail. *Id.*

continued to pay every creditor, its employees, its contractors, its officer-stockholders, and its operating expenses in preference to taxes owed to the government.¹²⁶

In *East Wind Industries, Inc. v. United States*, East Wind had a fifteen-year history of completing government contracts and also had a history of timely filing payroll tax returns and paying withholding taxes.¹²⁷ Despite bribery concerns within the industry in which East Wind was practicing, East Wind's vice president consulted with several professionals regarding financial and legal concerns that could result from this bribery activity.¹²⁸ As a consequence of the bribing activities, East Wind incurred monetary damages of about \$5.1 million.¹²⁹ The court determined that in order to prove that East Wind did not disfavor paying the government the taxes owed, East Wind could not show a conscious, intentional failure or reckless indifference.¹³⁰ East Wind contended that the reason for its failure to pay taxes in a timely manner was due to fraudulent criminal activities of officials at the defense agencies with which East Wind conducted business.¹³¹

The court in *East Wind Industries, Inc.* held that “[t]he Code does not bar consideration of financial difficulties in determining whether

¹²⁶ See *id.* The court determined that Staff IT was not entitled to fail to pay its penalty for not paying the government what it was owed. *Id.* The court ultimately held that Staff IT had not exercised ordinary business care and prudence, and thus, this failure to timely deposit taxes and file taxes was not the result of reasonable cause. *Id.*

¹²⁷ See *E. Wind Indus., Inc.*, 196 F.3d at 501 (furthering that beginning with the tax period ending in 1982 through the tax period in 1986, East Wind timely filed all appropriate tax returns but failed to pay its employment withholding taxes when such taxes were owed). The Taxpayers also experienced bribery activities during this time period, and they attempted to put a stop to the bribery activities of the defense agencies' employees. *Id.* The Taxpayers believed that in doing this they would cut down on any negative economic effect on business; unfortunately, these expectations were unrealistic, and this was not achieved. *Id.*

¹²⁸ See *id.* at 502 (explaining that the vice president consulted with accountants to discuss cash flow problems, payables, cash conservations, payroll, personal loans, and payment of taxes). He also consulted an attorney to discuss various legal matters and strategies to maintain the company. *Id.* Finally, the vice president took out many personal loans, including a mortgage, to provide additional cash and assets to pay essential employees; creditors, who if not paid would cut off current services that were essential to business operation; and some of the payroll taxes. *Id.*

¹²⁹ See *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 502 (3d Cir. 1999) (explaining that the taxpayers, due to this loss of revenue, filed suit against the defense agencies to recoup their damages). To gain back its damages, East Wind also filed suit against the defense agencies for tortious conduct. *Id.*

¹³⁰ See *id.* at 504 (stating that the taxpayer must show that the “failure to file a return timely was the result ‘neither of carelessness, reckless indifference, nor intentional failure’”).

¹³¹ See *id.* at 506 (stating that East Wind did exercise ordinary business care and prudence, but it was prohibited from doing so completely due to the fraudulent activities that were taking place with the customers that it had contracts with).

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reasonable cause has been established, and it does not differentiate between trust fund taxes and nontrust fund taxes.”¹³² Further, the court determined that the Treasury Regulations direct courts to look at all of the facts and circumstances regarding the taxpayer’s financial circumstances.¹³³ In its reasoning, the court held that the taxpayer’s failure to pay taxes did not amount to willful neglect because its financial well-being depended on the cash flow on government contracts and the corrupt officials of the defense agencies.¹³⁴

Additionally, in *Van Camp & Bennion v. United States*, the Ninth Circuit joined with the Second and Third Circuits and held that financial difficulties may constitute reasonable cause for nonpayment of taxes.¹³⁵ The court rejected *Brewery’s* bright-line rule because the court reasoned that ignoring the financial strain on the business could potentially ruin the corporation.¹³⁶ The court ultimately determined that a consideration of financial difficulties was a factor in deciding abatement of tax penalties and financial problems in Van Camp’s current situation and needed to be addressed.¹³⁷

Finally, in *Fran Corp. v. United States*, an electrical contractor for a commercial construction company was working under two contracts when the state withheld progress and cost overrun payments to Fran.¹³⁸

¹³² *Id.* at 507.

¹³³ *See id.* (explaining that the Treasury Regulations further direct the court to weigh the circumstances on a fact to fact basis to determine whether the taxpayer would not suffer “undue hardship [or] substantial financial loss” from the payment of taxes owed to the government). The court further stated that these regulations have been in place for a long period of time, have not been amended, and should not be changed. *Id.* The court ultimately found that the regulations currently in place required a factual assessment of the taxpayer’s financial situation to determine ordinary business care and prudence. *Id.*

¹³⁴ *See id.* at 508 (examining that the government wanted the court to ignore the language of § 6651 in interpreting the regulation and not factor in the struggle of determining which creditors to pay in a situation of financial distress). The court further stated that the regulations direct the courts to inquire as to the expenditures that the business possessed at the time of the failure to file or deposit taxes. *Id.* Additionally, East Wind’s ability to pay its debts was controlled by the defense agencies that were participating in criminal conduct. *Id.* East Wind had to rely on the contracts that it had with the government and did not have much bargaining power to prevent the criminal conduct. *Id.*

¹³⁵ *See Van Camp & Bennion v. United States*, 251 F.3d 862, 868 (9th Cir. 2001) (finding that the *Brewery* holding reads outside of the reasonable cause exception to mandatory penalties in tax cases).

¹³⁶ *See id.* (holding that a corporation’s financial difficulties can be a factor in deciding whether the abatement of penalties is applicable). The court further found that the analyses given in *Fran* and *East Wind* were more persuasive because both cases factor in financial difficulty rather than dismiss it. *Id.*

¹³⁷ *See id.* (reasoning that the Treasury Regulations direct the court to consider all financial circumstances and financial difficulties).

¹³⁸ *See Fran Corp. v. United States*, 164 F.3d 814, 815 (2d Cir. 1999) (positing that the state withheld progress and cost overrun payments to Fran that ultimately totaled \$454,854). The

Due to these financial difficulties, Fran failed to pay taxes totaling \$286,000.¹³⁹ Here, the court rejected the *Brewery* court's finding that financial difficulties cannot constitute reasonable cause, and Fran argued that the application of such a bright-line rule as applied by *Brewery* would be "inconsistent with Congress' creation of a 'reasonable cause' exception and the Treasury Regulations concerning the factual circumstances a taxpayer must allege to benefit from it."¹⁴⁰

Also, the court reasoned that rejecting *Brewery*'s bright-line rule was proper because "[s]uch a rule finds no support in either the penalty provisions of the statute or in the longstanding Treasury Regulations drafted to implement those provisions."¹⁴¹ The court further acknowledged that the government has not provided a basis to ignore the intent of Congress's creation of such regulation, and the court should not depart from the established practice of a case-by-case assessment of all facts and circumstances surrounding the taxpayer's financial situation.¹⁴² The court in *Fran* held that, because the taxpayer made the decision to fund numerous auto leases and repairs before paying the IRS, Fran did not have an argument that would constitute reasonable cause.¹⁴³ Next, Part III of this Note analyzes the current approaches that the circuits use, why they do not work, and why they impact small businesses and the American economy.¹⁴⁴

state insisted that Fran complete its work despite nonpayment, or Fran would risk losing the full contract through a breach. *Id.* Within another year, St. Thomas, a party to Fran's second contract, defaulted on its payments to Fran, which totaled \$157,314. *Id.* Fran exhausted all credit facilities and tried to pay workers fully and certain creditors partially to ensure completion of two projects that had not been finished. *Id.* During this time, Fran did not have sufficient cash flows or assets to pay all of its employees, creditors, and taxes. *Id.* As a result, Fran faced severe financial difficulties. *Id.*

¹³⁹ See *id.* at 815 (establishing that Fran filed its quarterly tax returns late for the second and fourth quarters).

¹⁴⁰ *Id.* at 818.

¹⁴¹ *Id.*

¹⁴² See *id.* at 819. The court ultimately held in *Fran* that Fran had not established reasonable cause because the corporation continued to pay \$3500 in monthly rent to the president of Fran and incurred auto leasing and repair expenses in addition to entertainment expenses. *Id.* The appellate court ultimately agreed with the district court that Fran had failed to establish reasonable cause when it paid other expenses and creditors over the government. *Id.*

¹⁴³ See *id.* (establishing that the expenses of repairs included the repair of Porsches that Fran tried to characterize as an essential aspect of completing the two construction jobs).

¹⁴⁴ See *infra* Part III (analyzing the current approaches that various circuits use and why these approaches are impacting our economy and harming small businesses).

III. ANALYSIS

Small business owners have proven to be a very vulnerable group, and thus, many small businesses struggle and fail every year.¹⁴⁵ While the *Code of Federal Regulations* addresses failure to make a deposit of taxes, the reasonable cause standard for financial difficulty has not been clearly defined.¹⁴⁶ The circuits are currently split on how to interpret this reasonable cause standard as applied to financial difficulty.¹⁴⁷ The Sixth Circuit currently uses a bright-line rule that is too strict because it explains that paying other creditors over the government does not constitute reasonable cause.¹⁴⁸ The Second, Third, Seventh, and Ninth Circuits use a multi-factor test based on two factors that are overly broad.¹⁴⁹

Therefore, it is imperative that all courts recognize the same clearly defined reasonable cause standard in order to establish uniformity and ensure that small businesses that truly struggle are able to keep their doors open for years to come.¹⁵⁰ Part III analyzes the need for a uniform standard of reasonable cause in the context of financial difficulty.¹⁵¹ First, Part III.A addresses the importance of taxation and also the small business

¹⁴⁵ See Efrat, *supra* note 57, at 177 (observing that small businesses fuel the economy and also how many small businesses are vulnerable, and stating that thirty percent of small businesses close within two years of beginning operation).

¹⁴⁶ See Treas. Reg. § 301.6651-1 (providing what happens when failing to file a tax return, but using the reasonable cause standard that exempts the taxpayer from paying a penalty, a standard that is unclear).

¹⁴⁷ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 800 (5th Cir. 2007) (discussing that the Court of Appeals for the Fifth Circuit acknowledged this circuit split of whether financial difficulty can constitute reasonable cause for failure to pay taxes and avoid the penalty as imposed by 26 U.S.C. § 6656). The court in *Q.E.D., Inc. v. United States* argued that the reasonable cause standard “requires a factual inquiry into the circumstances of the particular case.” *Q.E.D., Inc. v. United States*, 55 Fed. Cl. 140, 141 (2003) (holding that the factual evidence did not comply with the exercise of ordinary business care and prudence and thus was not excused by a claim of undue hardship).

¹⁴⁸ See *Brewery, Inc. v. United States* 33 F.3d 589, 592–94 (6th Cir. 1994) (explaining that the courts should only look to whether other creditors were favored over the government and not to any other factors regarding keeping the business open).

¹⁴⁹ See *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 507–11 (3d Cir. 1999) (finding that the bright-line rule is troubling as it is inconsistent with Congress’s creation of the exception and that the multi-factor test has economic benefits). See also *Van Camp v. United States*, 251 F.3d 862, 868 (9th Cir. 2001) (pointing out that if the potential ruin of a corporation will not happen due to the tax burden, a business cannot claim reasonable cause).

¹⁵⁰ See *infra* Part IV (proposing a new test that keeps businesses in check regarding the payment of taxes but also recognizes that if businesses shut their doors, this will hurt the economy, and this must be accounted for in our legal system).

¹⁵¹ See *infra* Parts III.B–III.D (recognizing the circuit split and comparing and contrasting how each will affect small businesses that truly struggle).

struggle of failing too quickly.¹⁵² Next, Part III.B examines the bright-line rule and why it is too strict.¹⁵³ Third, Part III.C explains and examines the overbroad multi-factor test and why this should be tightened.¹⁵⁴ Finally, Part III.D analyzes the contribution of small businesses to the economy and the negative impacts of small businesses closing, while urging the importance of defining reasonable cause for financial difficulty.¹⁵⁵

A. Importance of Taxation and Why Small Businesses Should Be Held Accountable for Paying Taxes but Should Also Account for Financial Difficulty

While revenue to support America's services is crucial to growing and maintaining America's status, small businesses are also very likely to fail in today's market.¹⁵⁶ Therefore, this Note argues for a uniform standard to define reasonable cause for failure to pay or deposit taxes as it applies to financial difficulty.¹⁵⁷ Part III.A examines the financial struggle that small businesses encounter while still providing for much of the American economy, which will prove that courts need a new way to interpret this reasonable cause standard.¹⁵⁸

¹⁵² See *infra* Part III.A (reflecting that taxes are important for infrastructure and growth but should not penalize small businesses that merely wish to remain open despite financial trouble).

¹⁵³ See *infra* Part III.B (showing that the bright-line rule is inconsistent with Congress's definition of reasonable cause and why this rule does not work for economic growth).

¹⁵⁴ See *infra* Part III.C.

¹⁵⁵ See *infra* Part III.D (comparing both standards and addressing that a new standard needs to be implemented to account for true financial difficulty among small businesses).

¹⁵⁶ See Efrat, *supra* note 57, at 179 (summarizing that while small businesses employ more than half of the workforce in the United States, a number of studies have shown that small businesses fail due to the tax burden). See also Lisa McQuerrey, *The Economy's Effects on Small Businesses*, CHRON, <http://smallbusiness.chron.com/economys-effects-small-businesses-10269.html> [<http://perma.cc/3A2Z-246C>] (examining the economic conditions and the impact that such conditions have on businesses). When the economy is in a slump, small businesses are more cautious with expenditures, and this turns into decreased revenue. *Id.* Additionally, an economic downturn can negatively impact long-term small business health because of the slow profit stream and the inability to repay creditors. *Id.* Small businesses are hit harder in a slow economy because resources are limited and downsizing the workforce is also an added stress. *Id.* On the other hand, when the economy is strong, small businesses are more likely to hire more employees, increase product lines, and take on new ventures. *Id.*

¹⁵⁷ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 800 (5th Cir. 2007) (analyzing the current circuit split and explaining that a uniform standard to define the reasonable cause for financial difficulties does not exist).

¹⁵⁸ See *infra* notes 159–65 and accompanying text (examining the financial difficulty of small businesses and the likelihood that they will fail if their financial struggles are not accounted for).

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Small businesses employ more than half of the United States labor force and contribute to the addition of nearly two-thirds of all new jobs in America.¹⁵⁹ Yet small businesses face disproportionate tax burdens in operating their businesses, and as a result, many small businesses encounter tax problems.¹⁶⁰ In 2004, a study revealed that small businesses pay corporate tax rates anywhere from twenty-five percent to thirty percent.¹⁶¹ Additionally, the federal tax code disfavors small businesses by only offering benefits that favor large businesses that accumulate a relatively high capital expenditure.¹⁶² Because of these additional burdens placed on small businesses, nearly fifty percent will close within four years of opening, and forty percent will survive after six years or more.¹⁶³ Due to these already inhibiting factors, small businesses are set up to fail.¹⁶⁴ The current sections in the *United States Code* and the *Code of Federal*

¹⁵⁹ See Efrat, *supra* note 57, at 175 (demonstrating statistics that small businesses drive the American labor force and generate many new jobs for the United States and, thus, are an important part of the American economy).

¹⁶⁰ See *id.* at 180–81 (complaining that the federal tax code treats small business owners differently).

¹⁶¹ See Innovation & Information Consultants, Inc., *The Impact of Tax Expenditure Policies on Incorporated Small Businesses*, SMALL BUS. ADMIN. (2004), <http://www.sba.gov/advo/research/rs237tot.pdf> [<http://perma.cc/G63J-EJRJ>] (asserting that this range of twenty-five to thirty percent is much higher than what large businesses pay for their corporate tax rates). The Tax Cuts and Jobs Act, signed in December 2017, changed the business tax that small businesses pay. See *How Much Do Small Businesses Pay?*, THE BALANCE (Feb. 2018), <https://www.thebalance.com/how-much-tax-do-small-businesses-pay-3974568> [<http://perma.cc/3D5B-4G6J>] (analyzing the current tax reform and how it applies to and affects small businesses). Generally, about seventy-five percent of small businesses are called “pass-through” entities and pay taxes at the personal tax rate of the owner. *Id.* The new effective tax rate based on the tax reform for small businesses is about 19.8%. *Id.* This effective rate is “calculated by dividing the total tax paid by the taxable income.” *Id.* Additionally, due to the tax reform, the small business dollar limit for expensing equipment purchases has increased substantially. *Will Tax Reform Give Small Businesses Much Needed Relief?*, EXPERIAN (Dec. 2017), <http://www.experian.com/blogs/small-business-matters/2017/12/18/will-tax-reform-give-small-businesses-much-needed-relief/> [<http://perma.cc/HPT7-T7SC>] (examining the tax changes for small businesses). Specifically, the equipment expenses for small businesses are \$1 million, up from \$510,000 in 2017. *Id.*

¹⁶² See Efrat, *supra* note 57, at 180–81. This unfair application of tax exceptions can be explained by the following example:

The fair market value of meals provided by an employer to an employee is generally taxable to the employee, unless the employer furnishes meals to the employees at the employer’s cafeteria. The requirement that the meals be provided on the employer’s business premises in order to be excluded from the employee’s tax suggests that large businesses would primarily qualify for this tax benefit as they are large enough to have their own cafeteria.

Id.

¹⁶³ See *id.* at 177.

¹⁶⁴ See *id.* (showing statistics for the percentage of small businesses that fail).

Regulations do not protect small businesses that face financial difficulty and wish to keep their doors open.¹⁶⁵ Therefore, the *Code of Federal Regulations* needs to be clearly defined in order to assist small business owners and ensure economic growth. Part III.B discusses the inconsistency with the bright-line rule as used by the Sixth Circuit.¹⁶⁶

B. The Sixth Circuit Bright-Line Rule Is Too Strict and Does Not Account for Financial Difficulty

To determine reasonable cause for financial difficulty, the Sixth Circuit has used a bright-line rule that explains that financial difficulties never constitute reasonable cause to excuse the penalties for nonpayment of taxes.¹⁶⁷ In addition, the Sixth Circuit courts have determined that paying other creditors does not constitute reasonable cause and, instead, constitutes willful neglect to avoid payment to the government.¹⁶⁸ Section III.B.1 examines the holdings and reasoning behind the Sixth Circuit cases that have used this standard.¹⁶⁹ Section III.B.2 then explains why the bright-line rule, as applied, is inconsistent with Congress's creation of the reasonable cause exception,¹⁷⁰ and Section III.B.2 concludes by examining why this standard is too strict and why reliance on such a strict standard will have negative economic impacts.¹⁷¹

1. An Examination of the Bright-Line Rule

In *Brewery, Inc. v. United States*, Brewery, Inc. brought an action to recover refund of penalties received due to failure to timely deposit taxes according to 26 U.S.C. § 6651(a)(2).¹⁷² The court identified that, although revenue had been lost and profits dropped, financial difficulty was not

¹⁶⁵ See Treas. Reg. § 301.6651-1 (addressing that financial difficulty and due diligence of business owners has not been defined properly and leaves room for interpretation).

¹⁶⁶ See *infra* Part III.B (analyzing the bright-line rule and the inconsistency of this current approach with the intentions of Congress).

¹⁶⁷ See *Brewery, Inc. v. United States*, 33 F.3d 589, 592 (6th Cir. 1994) (criticizing the financial difficulty standard and stating that it should never be applied as it deprives the government of funds).

¹⁶⁸ See *id.* (defining that reasonable cause should never be used as a factor when determining a tax penalty because this supports bad business behavior and hurts the economy).

¹⁶⁹ See *infra* Section III.B.1.

¹⁷⁰ See *infra* notes 179–83 and accompanying text.

¹⁷¹ See *infra* notes 184–87 and accompanying text (furthering why this strict standard will have negative economic impacts and businesses will be forced to shut down).

¹⁷² See *Brewery, Inc.*, 33 F.3d at 592 (explaining that the main route of access to the restaurant was cut off, and thus, unexpected loss of revenue resulted, and creditors were without payment).

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enough to justify missed tax payments to the government.¹⁷³ In this case, Brewery intentionally paid other creditors in order to keep the business operating.¹⁷⁴ This is the first example of a struggling business that favored other creditors over the government in order to keep the business open and was still penalized.¹⁷⁵

Additionally, the next example of *Thibodeau v. United States* again demonstrates how the court disfavors those who place other creditors before the government.¹⁷⁶ Thibodeau paid other creditors in order to keep the business operating, which the court did not favor and held that this action did not constitute reasonable cause.¹⁷⁷ Again, the court disfavored those businesses that paid other creditors to keep the business operating. This bright-line rule has had much criticism and has proven to be inconsistent with what Congress intended to create for the reasonable cause standard.¹⁷⁸

¹⁷³ See *id.*

¹⁷⁴ See *id.* (stating that Brewery must pay the price for this decision, and the penalties will be enforced regardless of its desires to keep the doors open).

¹⁷⁵ See *id.* (examining that the court did not consider the economic impact the business closing would have on the economy and, instead, only focused on the payment owed to the government).

¹⁷⁶ See *Thibodeau v. United States*, 828 F.2d 1499, 1506 (11th Cir. 1987) (expressing that the taxpayer issued other checks to different creditors).

¹⁷⁷ See *id.* at 1506–07. The court made the following statement regarding nonpayment of taxes:

The responsible officer's actions before the due date for payment of the withheld taxes satisfies the "willfulness" requirement under section 6672: when the responsible officer . . . knows that the withheld funds are being used for other corporate purposes, regardless of his expectation that sufficient funds will be on hand on the due date for payment over to the government. . . . The taxpayer argues that the checks he signed were necessary to keep the corporation operating as a going concern, but the government cannot be made an unwilling partner in a business experiencing financial difficulties. . . . It is no excuse that, as a matter of sound business judgment, the money was paid to suppliers and for wages in order to keep the corporation operating as a going concern—the government cannot be made an unwilling partner in a floundering business.

Id.

¹⁷⁸ See, e.g., *E. Wind Indus., Inc. v. United States*, 196 F.3d 499 (3d Cir. 1999) (showing that Congress's creation of this standard is different than it is currently interpreted, and this interpretation does not analyze the facts and circumstances surrounding the taxpayer's financial difficulties).

2. This Bright-Line Rule Is Inconsistent with the Intent Behind the Creation of a Reasonable Cause Exception and Creates Negative Economic Impacts

Treasury Regulation § 301.6651-(c)(1) specifically requires courts to examine “all the facts and circumstances of the taxpayer’s financial situation.”¹⁷⁹ Yet the bright-line rule ignores the Treasury Regulation and instead states that financial difficulty can never constitute reasonable cause for failure to pay or deposit taxes.¹⁸⁰ This bright-line rule is inconsistent with what Congress has approved and, thus, is contrary to law that has been imposed since 1916.¹⁸¹ The Treasury Regulation that has been imposed and considered law tells courts to determine whether the taxpayer who has failed to pay taxes would have suffered “undue hardship” or “substantial financial loss” from the payment of taxes.¹⁸² This analysis, as given by *East Wind Industries, Inc.*, demonstrates that the bright-line rule is not properly applying the *Code of Federal Regulations* and is failing to take into account financial circumstances of small businesses.¹⁸³

This bizarre misinterpretation of the Treasury Regulations can have severe economic impacts on small businesses. The Internal Revenue Service (IRS) took a dramatic position that if a taxpayer cannot afford to pay taxes, regardless of the cause or issue at hand, the business should shut down.¹⁸⁴ The court in *East Wind Industries, Inc.* noted that the economy would be negatively impacted by such an approach because the “amount of money flowing into the economy . . . is reduced as a result of increased unemployment, idle buildings and plants, and decreased sales of goods and services.”¹⁸⁵ The court further reasoned that, when a business is able to keep its doors open at a minimal operating level to collect money to pay delinquent taxes and other debts, the economy and the IRS benefit.¹⁸⁶ Finally, the finding that paying other creditors over the

¹⁷⁹ *Id.* at 499.

¹⁸⁰ *See Brewery, Inc. v. United States*, 33 F.3d 589, 593 (6th Cir. 1994).

¹⁸¹ *See E. Wind Indus., Inc.*, 196 F.3d at 507 (“Where regulations have continued over a long period of time without substantial change and have applied to unamended or substantially reenacted statutes, they are deemed to have received the approval of Congress and thus have the effect of law.”).

¹⁸² *Id.*

¹⁸³ *See id.* (examining the difference that the Treasury Regulation applies and uses for financial circumstances and the differences that exist in the *Brewery* decision).

¹⁸⁴ *See id.* (stating the public policy for payment of taxes has been a stringent standard).

¹⁸⁵ *Id.*

¹⁸⁶ *See id.* *See also supra* Section II.B.1 (expressing that small businesses are the driver of the economy, and without them, the economy would suffer). Small businesses assist minorities and women in the creation of entrepreneurship, and if a small business is able to keep its

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government is not reasonable cause, as the bright-line rule suggests, misinterprets the Treasury Regulations and the economic impacts of such harsh standards.¹⁸⁷ Therefore, it is essential that, in order to avoid negative economic impacts of small businesses closing doors, the bright-line rule is loosened to examine surrounding financial circumstances. However, as the next Part suggests, the multi-factor test set out by the Second, Third, Seventh, and Ninth Circuits also has its downfalls.¹⁸⁸

C. *Second, Third, Seventh, and Ninth Circuits' Multi-Factor Test Is Too Broad*

The multi-factor test as used by the Second, Third, Seventh, and Ninth Circuits assesses whether: (1) the taxpayer favored "other creditors over the government, which weighs against a finding of reasonable cause, and (2) the [taxpayer demonstrated a] willingness to decrease expenses and personnel, which weighs in favor of a finding of reasonable cause."¹⁸⁹ These factors leave too much room for interpretation and can easily be abused by either the court or the taxpayer.¹⁹⁰ Should the taxpayer be penalized for favoring other creditors if they are necessary to keep the small business open?¹⁹¹ Additionally, what qualifies for a decrease of personnel? These are both problems that the test does not address.¹⁹² Part III.C analyzes the broadness of the multi-factor test as applied and furthers why the current test must be tightened.¹⁹³

Unlike the bright-line rule, the multi-factor test used in *Van Camp & Bennion v. United States* explained that the bright-line rule cannot be

doors open at minimal operation during the tax delinquency period, more women and minorities will keep their employment and will be able to keep their businesses running. Finally, small businesses employ a high percentage of the American workforce. Without keeping the business at a minimal operating level, unemployment will rise, and businesses will be forced to shut down.

¹⁸⁷ See *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 509 (3d Cir. 1999) (arguing that paying creditors who were essential to maintain the operating business cannot constitute a conscious or intentional disregard to pay the government).

¹⁸⁸ See *infra* Part III.C (analyzing the multi-factor test and why it is inefficient and extremely arbitrary).

¹⁸⁹ *Staff IT, Inc. v. United States*, 482 F.3d 792, 801 (5th Cir. 2007).

¹⁹⁰ See *id.* (analyzing that this test is still too broad as it leaves discretion to the courts to give a business a tax penalty because it was attempting to remain in operation).

¹⁹¹ See *id.* (questioning if this test is still too broad and whether it is too harsh on the business).

¹⁹² See *id.* (criticizing that the test is too broad and does not help to define the reasonable cause standard but only makes it more difficult for the courts to interpret).

¹⁹³ See *infra* notes 194–211 and accompanying text (distinguishing the multi-factor test as applied to cases).

applied because it reads outside of the Treasury Regulation.¹⁹⁴ The court in *Van Camp* determined that “[i]f the potential ruin of a corporation is not relevant, then the reasonable cause exception is virtually meaningless.”¹⁹⁵ This determination is too broad as it does not look at how the potential ruin of a corporation came to be; it is merely looking to determine if the ruin of a corporation is relevant.¹⁹⁶ Additionally, the court in *Fran Corp.* also applied the multi-factor test in deciding whether Fran had exercised “ordinary business care and prudence.”¹⁹⁷ The court determined that Fran did not exercise ordinary business care because the company continued to pay rent to the president of Fran.¹⁹⁸ However, the court in *Fran Corp.* failed to address whether this monthly rent was essential to maintain the operation of the business and, in fact, did not address the reason for this payment at all.¹⁹⁹ This is an example of the issue with the multi-factor test: a creditor was paid over the government, but the payment was not assessed to determine if it was essential to the operation and existence of the business.²⁰⁰

¹⁹⁴ See *Van Camp & Bennion v. United States*, 251 F.3d 862, 868 (9th Cir. 2001) (criticizing the reasoning in *Brewery* as it read outside of the regulation and should be interpreted to determine merit of financial difficulty based on the financial situation at hand).

¹⁹⁵ *Id.*

¹⁹⁶ See *id.* (distinguishing that although different from the Sixth Circuit’s standard, the standard in *Van Camp & Bennion* still does not account for economic impacts).

¹⁹⁷ *Fran Corp. v. United States*, 164 F.3d 814, 819 (2d Cir. 1999).

¹⁹⁸ See *id.* (demonstrating that monthly rent of \$3500 was still paid, but this was not addressed as to the relevancy of maintaining the business operations). The money that was paid was used to keep the business operating, as rent is a necessary expense, but the court did not consider the importance of paying rent over the government. *Id.* Due to the court not considering the importance of paying rent and its direct correlation to operating the business, the court held that the business had paid other creditors over the government, and this did not constitute reasonable cause. *Id.* Finally, the court held that a failure to deposit trust fund taxes does not always eliminate financial difficulties from constituting reasonable cause. *Id.*

Additionally, the court in *Synergy Staffing, Inc. v. U.S. Internal Revenue Service* found that the taxpayer had paid other previous liabilities before paying the government, and thus, financial hardship was not reasonable cause. *Synergy Staffing, Inc. v. U.S. Internal Revenue Serv.*, 323 F.3d 1157, 1161 (9th Cir. 2003). The court found that the taxpayer failed to timely deposit taxes and that the taxpayer had failed to disclose what funds it did have available. *Id.* The court reasoned that because the taxpayer failed to produce evidence of how it spent the funds that it did have, this did not constitute reasonable cause for failure to timely pay and file. *Id.* The court did note that Synergy had presented evidence that during the years of failure to pay taxes, its line of credit had been significantly reduced through no fault of its own, which had a negative effect on the ability to pay taxes on time. *Id.* at 1160.

¹⁹⁹ See *Fran Corp.*, 164 F.3d at 819 (stating that because the rent was paid, Fran Corp. failed the multi-factor test of favoring other creditors, and this was not determined to constitute exercising ordinary business care and prudence).

²⁰⁰ See *id.* This creditor was paid to keep the business running, and it was still determined that the business did not have reasonable cause for failure to file and pay the tax. *Id.*

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Next, *Staff IT, Inc.* is analyzed. The court in *Staff IT* applied the multi-factor test to determine if cutbacks, favoring other creditors, and the attacks of September 11th were enough to constitute reasonable cause.²⁰¹ The court determined that because Staff IT paid for its operating expenses and paid other creditors, such as contractors and employees, it did not meet reasonable cause.²⁰² This determination is troubling because the court dismissed the fact that operating expenses were paid over the government.²⁰³ This again addresses the concern, as stated above, that this multi-factor test is too broad.²⁰⁴ The multi-factor test only looks at whether other creditors were favored over the government, and if they were, this weighs against reasonable cause for financial difficulty.²⁰⁵

Finally, if the Treasury Regulation is again examined, it can be determined that this multi-factor test fails what Congress has created.²⁰⁶ Congress created a standard that looks at “all facts and circumstances of the taxpayer’s financial situation.”²⁰⁷ If the multi-factor test continues to be applied as it was in the previously mentioned cases, this test will continue to fail to see all facts and circumstances.²⁰⁸ This test is only looking to whether other creditors were paid over the government and whether the business cut down on unnecessary expenses.²⁰⁹ This test fails to look at why the creditors were paid and, again, goes back into the economic impact discussion of shutting down a business.²¹⁰ Therefore, this multi-factor test is too broad and needs to be clearly defined to ensure that courts are doing what Congress intended and looking at all

²⁰¹ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 801 (5th Cir. 2007) (addressing that the company faced significant financial loss and that, due to the September 11th attacks, the overall economy dropped making Staff IT unable to timely file their returns).

²⁰² See *id.* (noting that Staff IT “continues to pay virtually all its creditors, its employees, its contractors, its officer-stockholders, and its operating expenses in preference to its tax obligations”).

²⁰³ See *id.*

²⁰⁴ See *id.* (arguing that this standard still does not define reasonable cause and leaves the door closed for businesses to flourish and receive economic success).

²⁰⁵ See *id.*

²⁰⁶ See Treas. Reg. § 301.6651-(c)(1) (explaining that the intentions were to force the courts to look at all facts and circumstances surrounding the business’s financial distress).

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 801 (5th Cir. 2007) (criticizing that this test does not truly look into all facts and circumstances of the business’s financial problems and only looks to whether other creditors were paid over the government when the business was facing hardship).

²¹⁰ See *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 509 (3d Cir. 1999) (addressing that everyone would benefit if the IRS loosened its current standards and the courts took into account economic factors of simply shutting down a business for delinquent payment of taxes).

surrounding circumstances of financial difficulty.²¹¹ Next, Part III.D discusses the contributions of small businesses to the economy and the need to implement a clear test to determine reasonable cause for financial difficulty.²¹²

D. The Need to Implement Stringent, Clearly Defined Measures That Use the Strictness of the Bright-Line Test to Tighten the Broadness of the Multi-Factor Test

As stated above, small businesses are a critical component of economic growth.²¹³ Small businesses contribute largely to local economies by bringing innovation and employment growth to the community where the small business is established.²¹⁴ As well as economic and employment growth, small businesses are a benefit for larger corporations due to the “completion of various business functions through outsourcing.”²¹⁵ Additionally, when a small business is flourishing in a local economy, this means that the business is paying higher taxes that are then used for schools, fire departments, police departments, etc.²¹⁶ Finally, small businesses grow to become large players in the national and international marketplace and often remain in the community in which the small business was first created.²¹⁷

The current standards of reasonable cause for failure to pay taxes only harm, instead of encourage, small business growth and thus harm the economy as a whole.²¹⁸ When small businesses fail in a local economy, the local economy will experience higher unemployment and a lower

²¹¹ See *supra* note 165 (analyzing the Treasury Regulation and how this should be applied today).

²¹² See *infra* Part III.D.

²¹³ See *supra* Section II.B.1 (demonstrating the importance of small businesses in the American economy).

²¹⁴ See *How Important Are Small Businesses to Local Economies?*, CHRON, <http://smallbusiness.chron.com/important-small-businesses-local-economies-5251.html> [<http://perma.cc/UV62-6VW2>] (expanding that small businesses stimulate economic growth by creating new employment opportunities for people who may not have such an opportunity with a larger corporation).

²¹⁵ *Id.*

²¹⁶ See *id.* (noting that consumers investing in small businesses in local economies are essentially giving back to their communities).

²¹⁷ See *id.* (furthering that small businesses do not always stay small and that many new businesses become large corporations that benefit the local economies in which they originated).

²¹⁸ See Rutherford Campbell, *Regulation A: Small Businesses' Search For "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 84 (2006) (stating that small businesses are crucial to people's everyday lives and vital to the United States economy as a whole).

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standard of living.²¹⁹ Additionally, when small businesses fail and must shut down, their lack of presence harms historically disadvantaged groups such as women, minorities, and immigrants entering the American economy.²²⁰ Furthering the negative impacts, when small businesses are forced to close their doors, local governments, schools, roads, and public services suffer due to the lack of tax contributed to the local economy.²²¹ Finally, without the significant creation of small businesses, the American economy as a whole will experience less innovation and new, organic ideas.²²² The importance of a strong small business presence in the American economy speaks for itself and should be protected in order to ensure economic stability, job creation, and a surplus of innovation for years to come.²²³

The current standards in place do not look at true financial difficulty among small businesses.²²⁴ The bright-line rule disregards financial difficulty altogether and explains that this will never constitute reasonable cause.²²⁵ This is troubling in many regards because if financial difficulty is never a factor in the assessment of reasonable cause, like the court stated in *East Wind Industries, Inc.*, the economy as a whole will suffer because more businesses will have to close their doors and overall unemployment will increase.²²⁶ Additionally, the courts in other cases have determined

²¹⁹ See David Ingram, *The Advantages of Businesses in the Local Economy*, CHRON, <http://smallbusiness.chron.com/advantages-businesses-local-economy-3289.html> [http://perma.cc/JN5Z-EUED] (expanding that when small businesses fail, disposable income decreases and home foreclosure rates spike). See also Campbell, *supra* note 218, at 81 (concluding that small business entrepreneurs generate a large amount of job creation and opportunities for historically disadvantaged groups, but when businesses fail, job creation decreases and disadvantaged groups are harmed significantly).

²²⁰ See Campbell, *supra* note 218, at 85–86 (quoting that “small business continues to be an important means for disadvantaged groups of people in the United States”).

²²¹ See Ingram, *supra* note 219 (analyzing the importance of business tax on the local economy, including income tax, property tax, and employment tax).

²²² See Campbell, *supra* note 218, at 86 (expanding the importance of innovation in the United States due to small businesses and arguing that “small firms generate 55% of all manufacturing product innovations and more than twice the innovations per employee as large firms”).

²²³ See *id.*

²²⁴ See *supra* Part III.B & Part III.C.

²²⁵ See *supra* Part III.B (explaining that the *Brewery* case does not look to financial difficulty and discusses that the government should not be a creditor that is held to a lower standard and less favored than other creditors).

²²⁶ See *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 509 (3d Cir. 1999) (reasoning that the overall fiscal health of the economy is reduced as a result of increased unemployment because businesses cannot keep their doors open and cannot generate enough revenue to keep staff). Additionally, businesses closing their doors due to failure to pay taxes results in idle buildings and plants and decreased sales of goods and services, both of which are a burden to the overall health of the economy. *Id.* Finally, if a taxpayer can keep a business

that paying other creditors, whose services are essential to maintaining the success and growth of the company, is not necessarily a bad practice to follow.²²⁷ Finally, the bright-line rule completely disregards what Congress implemented and does not look at the total facts and circumstances surrounding the reason for financial difficulty.²²⁸ The above-mentioned reasons demonstrate that the current bright-line rule that is used in the Sixth Circuit needs to be changed to a different approach to account for what was laid out in the regulations that Congress passed and should not be changed merely because the court does not want to factor in financial difficulty when determining reasonable cause.²²⁹ In the alternative, the multi-factor test used by the Second, Third, Seventh, and Ninth Circuits does not account for the economic impacts of shutting down a small business.²³⁰

On the contrary, although the multi-factor test used by the Second, Third, Seventh, and Ninth Circuits does have an element that determines if creditors were favored over the government, the test fails to address why these creditors were favored over the government.²³¹ This approach is also troubling, just as the bright-line rule is troubling.²³² The intent of the Treasury Regulations is to direct courts to “examine all the facts and circumstances of the Taxpayers’ financial situation.”²³³ The intent of the drafting of such regulations was to determine if the taxpayer would suffer undue hardship from the payment of such taxes.²³⁴ If a small business has

operating at a minimal level, the economy will not suffer and the above-mentioned problems will not occur. *Id.*

²²⁷ See *id.* (examining that if a taxpayer keeps a business open at an operational level in order to collect money that is owed to the government and other creditors, the economy and the IRS will benefit). The court reasoned that everyone will benefit in a situation like the one described because a business can still remain at an operational level while still contributing to the economy and creating jobs and employment opportunities for American workers. *Id.*

²²⁸ See *Staff IT, Inc. v. United States*, 482 F.3d 792, 801 (5th Cir. 2007) (addressing that the Treasury Regulations direct the courts to look at all of the factors and circumstances, rather than just those on the surface). The court further stated that these regulations have not changed for a long period of time, and by ignoring the facts and circumstances, the court cannot truly assess whether the business was willful in its failure to pay taxes. *Id.*

²²⁹ See *supra* Part III.B (analyzing that the bright-line rule does not factor in financial difficulty and that this is inconsistent with the regulations that were passed).

²³⁰ See *supra* Part III.C.

²³¹ See *Staff IT, Inc.*, 482 F.3d at 801 (showing that favoring any creditor over the government does not constitute reasonable cause under the multi-factor test).

²³² See *id.* (pointing out that this is troubling due to the fact that all circumstances are not taken into account when implementing either of the current tests).

²³³ *E. Wind Indus., Inc. v. United States*, 196 F.3d 499, 507 (3d Cir. 1999).

²³⁴ See *id.* at 507 (demonstrating that the regulation was put into place to analyze all of the facts behind the financial difficulty, not just whether other creditors were paid over the government). Although the court in *East Wind Industries* acknowledged that the regulation was put into place to determine all facts and circumstances surrounding the business’s

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to shut down merely because it paid other creditors before the government to keep its business running, this would show that the taxes paid would be a burden and an undue hardship on the business.²³⁵

Finally, the multi-factor test addresses that the potential ruin of a business is relevant but does not factor this in when creating the approach of favoring other creditors.²³⁶ Instead, although the circuits that use the multi-factor test believe that the potential ruin of a corporation is relevant when assessing reasonable cause, the multi-factor test fails to address that favoring other creditors over the government in order to keep a business's doors open is relevant when assessing reasonable cause.²³⁷

Both approaches fail to take the pragmatic approach of addressing financial difficulty among small businesses and, instead, choose to define reasonable cause for financial difficulty to mean something completely different than what the drafters of the regulation had in mind.²³⁸ If financial difficulty among small businesses is not truly determined, more small businesses will fail, and this will only make it more difficult for small businesses to stay open in the future.²³⁹ The bright-line rule is too strict because it does not factor in financial difficulty at all and ignores the regulations currently in place.²⁴⁰ Additionally, the multi-factor test

inability to pay and file taxes, it stopped at that. *Id.* It only acknowledged this, but did not do anything to solve the problem. *Id.* The court in *East Wind Industries* did not assess all facts and circumstances. *Id.*

²³⁵ See *id.* (addressing that a factual assessment of the entire financial situation will be analyzed to determine if the business exercised ordinary business care).

²³⁶ See *Van Camp & Bennion v. United States*, 251 F.3d 862, 868 (9th Cir. 2001) (illustrating that the potential ruin of a corporation is relevant, and if it is not relevant the reasonable cause exception is virtually meaningless).

²³⁷ See *E. Wind Indus., Inc.*, 196 F.3d at 509 (explaining that there would be a great financial strain on the business if financial difficulty was not assessed).

²³⁸ See *supra* Part III.B & Part III.C.

²³⁹ See *supra* Part III.B & Part III.C. Part III.B analyzes that financial difficulty is never assessed in any circumstance using the bright-line rule of the Sixth Circuit, and this will only cause a bigger economic impact. Additionally, the bright-line rule is inconsistent with Congress's implementation of the Treasury Regulation, and the bright-line rule needs to be reconstructed all together.

²⁴⁰ See *supra* Part III.B. The bright-line rule is harsh because it does not favor businesses and negligently disfavors economic growth. The bright-line rule will only hurt the economy and businesses due to the lack of understanding and support that the rule currently gives to businesses. In order to keep the economy running, a large part of which depends on small business success, the courts and Congress need to implement a more lenient test that favors businesses that are truly struggling. The test cannot be too lenient in that it creates abuse but must be lenient enough to allow the courts to consider whether each individual creditor was paid in an effort to keep the business running and keep the employees employed. This current bright-line rule does not take into account economic impacts and does not take into account the unemployment rates that will rise due to this rule. Therefore, this current standard (discussed in Part III.B) does not favor the economy and does not favor the success

recognizes that financial difficulty can be the potential ruin of a corporation but does not address why other creditors cannot be paid in order to keep the business open.²⁴¹ Therefore, a new approach needs to be implemented in order to define reasonable cause for financial difficulty and promote the growth of small businesses, rather than giving them more unnecessary burdens that they must face.²⁴² This new approach will use the multi-factor test as a starting point but will use the guidance of the Treasury Regulations to determine all facts and circumstances surrounding the business's financial difficulty.²⁴³ Next, Part IV proposes a new test to implement into the *Code of Federal Regulations* that clearly defines the reasonable cause standard.²⁴⁴

IV. CONTRIBUTION

Based upon the current circuit split, a new test must be implemented into the *Code of Federal Regulations*.²⁴⁵ Specifically, 26 C.F.R. § 301.6651(c) must be amended and clearly defined in order to create a uniform standard for reasonable cause.²⁴⁶ Currently, 26 C.F.R. § 301.661(c) names many factors that can trigger reasonable cause, but this leaves a messy standard for circuits to apply to cases.²⁴⁷ The current circuit split uses two different approaches that do not account for all financial factors and difficulties that businesses face.²⁴⁸

of small business or the success of the employment rates in the United States. *See supra* Part III.B.

²⁴¹ *See supra* Part III.C. Additionally, the reasonable cause standard as used in the multi-factor test does not clearly define what "cutting down on personnel" means and also does not define what paying other creditors to keep minimal operating levels will do for the economy. The multi-factor test starts the discussion of whether paying other creditors can constitute reasonable cause, but the multi-factor test fails to address whether, if other creditors are paid to keep the business running, the government will lose more in taxes.

²⁴² *See supra* Part II (explaining that businesses face many challenges that other large firms do not face and, because of this, are more likely to fail). A test that uses the multi-factor test as a starting point must be implemented in order to clearly define reasonable cause. This will eliminate the current circuit split and will also eliminate the inconsistency in the use of the current tests and approaches. This new test will also implement what Congress originally intended and will assess all facts and circumstances around the business's financial situation. Therefore, this test will implement a more well-defined and clear approach that will eliminate the circuit split and will also benefit the economy as a whole.

²⁴³ *See supra* Part II.

²⁴⁴ *See infra* Part IV.

²⁴⁵ *See infra* Part IV.A (pointing out that a new element test should be implemented).

²⁴⁶ *See supra* Part II.C (explaining the current reasonable cause definition under 26 C.F.R. § 301.6651(c)).

²⁴⁷ *See supra* Part II.C.

²⁴⁸ *See supra* Parts III.B & III.C (examining the current circuit split and analyzing that the circuits do not factor in the business's financial difficulty and instead impose a test that makes it difficult for businesses to succeed).

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This Note demonstrates that, instead of a factor approach, an element approach needs to be put in place to tighten the current standard to hold businesses accountable while still taking into account economic impact and financial struggles that businesses face.²⁴⁹ This element approach will be included in the *Code of Federal Regulations* and will amend 26 C.F.R. § 301.6651(c) to set a standard for all circuits to follow.²⁵⁰ This way, the circuits will have clear, definite guidelines of reasonable cause in regard to financial difficulty.²⁵¹ First, Part IV.A proposes a new element test to determine reasonable cause for financial difficulty.²⁵² Then, Part IV.B provides commentary regarding the new element test and addresses the current criticisms and downfalls of the current standards used by the circuits.²⁵³

A. *Proposed Element Test to Determine Reasonable Cause*

The element test first asks whether the taxpayer has favored other creditors over the government. The sub-element of this element asks whether those creditors were favored in order to keep the business running. This sub-element is essential because: (1) it takes into consideration economic factors of the business shutting down; and (2) realizes that these economic factors could be less favorable than owing taxes. The next element asks whether the business invested in speculative or illiquid assets. The final element asks whether the taxpayer decreased or eliminated spending on luxury items and unnecessary staff. The element test, in correct format, will look like this:

1. Whether the taxpayer has favored other creditors over the government?
 - a. *Were these creditors favored in order to keep the business running?*
2. Whether the business invested in speculative or illiquid assets?

²⁴⁹ See *infra* Part IV.A (proposing a new element test that takes into account financial difficulty within businesses while still ensuring that businesses will pay for the taxes that are owed to the government).

²⁵⁰ See *infra* Part IV.A.

²⁵¹ See *infra* Part IV.A (analyzing that this new test will create a more uniform approach, and circuits will not be split on how to handle and define reasonable cause).

²⁵² See *infra* Part IV.A.

²⁵³ See *infra* Part IV.B (examining the current standards with the new proposed element test and why the current standards do not help economic well-being or the economy as a whole).

3. Whether the taxpayer decreased or eliminated spending in luxury items and unnecessary staff?²⁵⁴

Next, Part IV.B provides commentary for this new element test and addresses why this is an improvement of the current reasonable cause definition as provided in 26 C.F.R. § 301.6651(c).²⁵⁵

B. Commentary

The proposed element test serves to correct the current approaches used to assess financial difficulty among businesses.²⁵⁶ Small businesses are especially hurt when dealing with tax burdens, but it is also important for these businesses to be held accountable for paying their taxes.²⁵⁷ Businesses drive our economy. They provide nearly half of all American jobs and give opportunities to otherwise disadvantaged groups.²⁵⁸ Small businesses are important for economic growth.²⁵⁹ Without accounting for the financial circumstances and difficulties that small businesses face, small businesses will continue to be very vulnerable.²⁶⁰ Although tax burdens are not the exclusive cause of small business failure, taxes are a major contributing factor.²⁶¹

The current reasonable cause definition in 26 C.F.R. § 301.6651(c) is not clear and has been misconstrued and misinterpreted by the circuits.²⁶² The current definition in the *Code of Federal Regulations* leaves a lot of discretion to the courts, which is evident by the circuit split.²⁶³ This element test shows that, by defining reasonable cause, businesses will be

²⁵⁴ See *supra* notes 245–51 and accompanying text. The italicized language is the author’s contribution.

²⁵⁵ See *infra* Part IV.B.

²⁵⁶ See *supra* Parts III.B & III.C (analyzing the inconsistencies of the reasonable cause definition and standard).

²⁵⁷ See *supra* Section II.B.3 (examining the tax burden on small businesses and why there is currently a disproportionate standard).

²⁵⁸ See *supra* Section II.B.1 (explaining that small businesses provide not only innovation and are full of individuals with high education levels but also provide many American jobs and contribute significantly to the overall job growth in the United States).

²⁵⁹ See *supra* Section II.B.1 (exploring the advantages of having a large portion of the economy driven by small businesses).

²⁶⁰ See *supra* Section II.B.2 (examining that small businesses face more disproportionate burdens than larger businesses and that, when economic downfalls impact our society, small businesses are usually hit the hardest and take longer to recover).

²⁶¹ See *supra* Section II.B.2 (discussing that small businesses disproportionately face many more tax burdens than larger firms because of the higher cost associated with tax compliance and the hours spent trying to adhere to all of the regulations put into place by the federal government).

²⁶² See *supra* Part II.C (stating the factors that are in place to define reasonable cause).

²⁶³ See *supra* Part II.C (outlining the factors for reasonable cause).

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held accountable for their failure to pay taxes, but the courts will also take into account the economic impacts.²⁶⁴ This approach works better than the tests currently in place because the bright-line standard is very strict and does not take into account financial difficulty, and the multi-factor test is easily abused and does not consider that other creditors may need paid, over the government, in order to keep the business running.²⁶⁵ The current test does not take this into account; it only states that if a business favored other creditors, this will weigh against the business when determining financial difficulty.²⁶⁶ On the other hand, the bright-line rule does not take into account any financial difficulty.²⁶⁷ This is inconsistent with what Congress has imposed and is unfavorably determining that financial difficulties among businesses should not be a factor in the analysis.²⁶⁸

This element test is an improvement on the standards currently in place because it gives clear, definite guidelines for the courts to follow when determining financial difficulty, while also taking into account the uniqueness of each business and the economic impact of imposing such penalties.²⁶⁹ Each business will face its own set of financial difficulties, but in order to keep the economy growing, keep tax revenues high to fund various programs in our society, and maintain the number of small businesses needed to fuel our economy, the current element approach needs to factor in that businesses will struggle but that favoring other creditors to keep their doors open is not a burden to our society.²⁷⁰

On the other hand, it can also be argued that this test is not an improvement because it gives a lot of variance in how courts can rule.²⁷¹ Because this test examines that if other creditors were favored, then this can constitute reasonable cause, the courts will have to determine which creditors are essential and which are not.²⁷² Critics of this proposal will argue this is not an improvement on the current standards because the courts will have to spend more resources and time on evaluating the

²⁶⁴ See *supra* Part IV.A (proposing the new element test).

²⁶⁵ See *supra* Parts III.B & III.C.

²⁶⁶ See *supra* Part III.C (arguing that while the multi-factor test uses a factor to determine whether the taxpayer favored other creditors over the government, this test fails to recognize the adverse impact of shutting down a business).

²⁶⁷ See *supra* Part III.B (exploring the bright-line rule and its inefficiencies).

²⁶⁸ See *supra* Part III.B (demonstrating that the determination of the Sixth Circuit, which stated that financial difficulty alone can never constitute reasonable cause, is inconsistent with what Congress had intended by requiring weighing facts and circumstances).

²⁶⁹ See *supra* Part IV.A (stating the proposed element test).

²⁷⁰ See *supra* Section II.B.2.

²⁷¹ See *supra* Part IV.A (articulating the new proposed element test).

²⁷² See *supra* Section II.B.3.

importance of such creditors.²⁷³ Although this is a counterargument to the test, this is a minor inconvenience for the courts.²⁷⁴ Specifically because the courts, with a little time spent on researching the nature of the business and inferring which are non-essential and essential creditors, can easily determine when the creditors are imperative to the business or not.²⁷⁵ Therefore, although there is a counterargument to this proposed test, with research and exploring the nature of the business, this issue can easily be avoided.²⁷⁶ Finally, Part V concludes as to the role that small businesses play in our economy and the need to implement a clear, definite standard for reasonable cause for failure to pay taxes.²⁷⁷

V. CONCLUSION

Taxes play a vital role in society and provide funding for various programs and institutions, such as education, defense, roadways, and social insurance programs. Additionally, small businesses are a key factor in the growth of the economy and are an essential aspect of employment and job opportunities. While the *Code of Federal Regulations* provides a loose reasonable cause definition, the circuits have different perspectives on how the reasonable cause for financial difficulty should be interpreted. The current approaches adopted by the circuits fail to address that small businesses are a key factor in the growth of our economy and explain that their financial difficulty can never constitute reasonable cause for failure to pay taxes.

Without a new test for all courts to follow, small businesses will continue to fail drastically and will only hurt the economy in the long run. The current standards set by the circuits do not take a pragmatic approach in the challenge to assess financial difficulty but, rather, assume that financial difficulty and favoring other creditors means that the government was not held high in the business's priorities. Therefore, this

²⁷³ See *supra* Section II.B.3 (furthering that small businesses are already facing hardships by current standards, and courts spending more time on evaluating the type of expense is a small cost to the benefit it could have in the long run for the economic health of the economy).

²⁷⁴ See *supra* Part III.D (supporting that small businesses are important to the economic health of the American economy and that, when businesses suffer, the economy as a whole suffers; thus, this small inconvenience for courts will, in turn, benefit the economy as a whole).

²⁷⁵ See *supra* Section II.B.1 (acknowledging the importance of small businesses and supporting that the courts can determine essential creditors easily by looking into the small business operations).

²⁷⁶ See *supra* Part III.D (exploring the importance of small businesses and the growth of our economy when small businesses flourish).

²⁷⁷ See *infra* Part V (concluding that small businesses are key to economic development, and standards must be implemented in the *United States Code* that recognize financial difficulty among small businesses and clearly define this standard).

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Note argued that, in order for financial difficulty to be assessed, the new element approach should ask whether the creditors that were favored over the government were essential to keep the business running.

Small businesses are vital to the health of the economy, and the current approaches in place only harm the businesses more and contribute to the overall failure rate of small businesses in the economy. Therefore, the new approach to follow will account for true financial difficulty and will be cognizant of businesses that are trying to keep their doors open for years to come.

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